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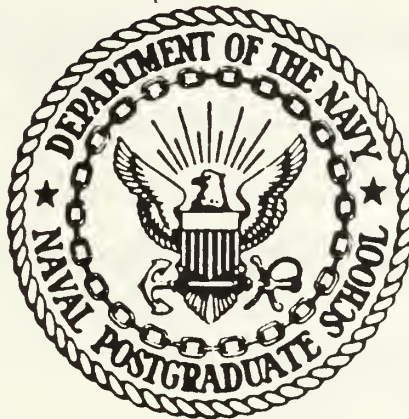
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THESIS

A STUDY OF THE PUBLIC ACCOUNTING
PROFESSION'S PROGRAM FOR AUDIT QUALITY AND
ITS APPLICABILITY TO THE NAVAL AUDIT SERVICE

by

Doreen E. Jagodnik

March 1987

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T234874

UNCLASSIFIED

SECURITY CLASSIFICATION OF THIS PAGE

REPORT DOCUMENTATION PAGE

1 REPORT SECURITY CLASSIFICATION UNCLASSIFIED			1b RESTRICTIVE MARKINGS			
2 SECURITY CLASSIFICATION AUTHORITY			3 DISTRIBUTION/AVAILABILITY OF REPORT Approved for public release; Distribution is unlimited			
5 DECLASSIFICATION/DOWNGRADING SCHEDULE			5 MONITORING ORGANIZATION REPORT NUMBER(S)			
PERFORMING ORGANIZATION REPORT NUMBER(S)			7a NAME OF MONITORING ORGANIZATION Naval Postgraduate School			
6a NAME OF PERFORMING ORGANIZATION Naval Postgraduate School		6b OFFICE SYMBOL (If applicable) Code 54		7b ADDRESS (City, State, and ZIP Code) Monterey, California 93943-5000		
ADDRESS (City, State, and ZIP Code) Monterey, California 93943-5000		9 PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER				
NAME OF FUNDING/SPONSORING ORGANIZATION		8b OFFICE SYMBOL (If applicable)		10 SOURCE OF FUNDING NUMBERS		
ADDRESS (City, State, and ZIP Code)				PROGRAM ELEMENT NO	PROJECT NO	TASK NO
				WORK UNIT ACCESSION NO		
TITLE (Include Security Classification) STUDY OF THE PUBLIC ACCOUNTING PROFESSION'S PROGRAM FOR AUDIT QUALITY AND ITS APPLICABILITY TO THE NAVAL AUDIT SERVICE						
PERSONAL AUTHOR(S) Magodnik, Doreen E.						
11 TYPE OF REPORT Master's Thesis		13b TIME COVERED FROM _____ TO _____		14 DATE OF REPORT (Year, Month, Day) 1987, March		15 PAGE COUNT 130
SUPPLEMENTARY NOTATION						
COSATI CODES			18 SUBJECT TERMS (Continue on reverse if necessary and identify by block number)			
FIELD	GROUP	SUB-GROUP	Audit; Quality			
ABSTRACT (Continue on reverse if necessary and identify by block number) The fundamental purpose of this thesis is to identify ways to enhance the quality of audit work performed by the Naval Audit Service. To this end, an in-depth examination is made of the public accounting profession's self-regulation initiatives, focusing on those quality elements that are so applicable to the Navy's internal auditing function. These include certification requirements of the American Institute of Certified Public Accountants, the nine elements of quality control outlined in Statements of Quality Control Standards No. 1, and the Peer Review Program. Finally, specific recommendations for the Naval Audit Service's quality program are presented, based on the application of appropriate private sector practices.						
DISTRIBUTION/AVAILABILITY OF ABSTRACT <input checked="" type="checkbox"/> UNCLASSIFIED/UNLIMITED <input type="checkbox"/> SAME AS RPT <input type="checkbox"/> DTIC USERS				21 ABSTRACT SECURITY CLASSIFICATION Unclassified		
NAME OF RESPONSIBLE INDIVIDUAL DR D.G. Matthews				22b TELEPHONE (Include Area Code) (408) 646-3339		22c OFFICE SYMBOL Code 54Ma

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A Study of the Public Accounting Profession's Program
for Audit Quality and Its Applicability to the
Naval Audit Service

by

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MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
March 1987

ABSTRACT

The fundamental purpose of this thesis is to identify ways to enhance the quality of audit work performed by the Naval Audit Service. To this end, an in-depth examination is made of the public accounting profession's self-regulation initiatives, focusing on those quality elements that are also applicable to the Navy's internal auditing function. These include certification requirements of the American Institute of Certified Public Accountants, the nine elements of quality control outlined in Statements on Quality Control Standards No. 1, and the Peer Review Program. Finally, specific recommendations for the Naval Audit Service's quality program are presented, based on the application of appropriate private sector practices.

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I. INTRODUCTION

A. BACKGROUND

With the federal deficit at all time highs, government spending has undergone great scrutiny in the past few years. The public outcry for accountability in government has focused new attention on the public sector's auditing and oversight functions. Indeed, one of the most aggressive actions of the early Reagan administration was the across-the-board firing of all fourteen inspectors general (IGs). William E. Thompson, then Chairman of the Board of the Institute of Internal Auditors, succinctly noted the change in internal audit philosophy thus:

IG's have a reputation for simply coming in and asking, 'Are you doing what you say you are?' What auditor-IG's ought to ask is, 'Should you be doing it in the first place? . . . What's the objective; Is what we're doing getting us there; If not, why not?' [Ref. 1:p. 31]

This role was formally outlined by the Comptroller General of the United States in his foreword to Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, promulgated in 1981:

In the past few years, we have seen an unprecedented interest in government auditing. Public officials, legislators, and private citizens want and need to know not only whether government funds are handled properly and in compliance with laws and regulations, but also whether government organizations are achieving the purposes for which programs were authorized and funded and are doing so economically and efficiently. [Ref. 2:p. i]

The overall mission of the Department of Defense (DoD) internal audit function is "to help DoD managers attain their goals by furnishing pertinent information, analyses, appraisals and recommendations pertinent to the managers' duties and objectives" [Ref. 3:p. 3-1]. To this end, it has recently issued a new version of its Internal Audit Manual, in order to standardize policies and procedures across the service audit agencies and to:

help DoD auditors and internal audit and internal review organizations comply with standards, policies, and procedures promulgated by the Congress, the Comptroller General of the United States, the Office of Management and Budget, the President's Council on Integrity and Efficiency, and the Department of Defense. [Ref. 3:p. i]

DoD has also instituted a new audit planning system that coordinates the efforts of the three service audit agencies and which stresses functional auditing vice location and compliance auditing.

The Naval Audit Service performs internal auditing throughout the Department of the Navy, providing an independent evaluation of the efficiency and effectiveness with which resources are being used. In recent years, however, overemphasis on financial and compliance audits made it difficult for the agency to justify its own cost-effectiveness, a phenomenon that Thompson had warned IGs about in 1981:

If IG's are geared only to finding waste and fraud, they could end up like a dentist, i.e., if he does a good job of getting the patient to brush teeth regularly, you end up not needing the dentist any more. [Ref. 1:p. 32]

DoD selected the Naval Audit Service as the first subject in its recent sweep of Quality Assurance Reviews. A congressionally-initiated review by the General Accounting Office was also recently completed, and the Navy is currently enhancing its performance standards, revamping staff programs, revising audit manuals, and more, in order to improve the usefulness and reliability of its audits.

While the auditing mission of the Naval Audit Service and a public accounting firm are not the same, auditing in the private sector has also undergone considerable criticism and realignment over the past decade. Indeed, a recent article stated that the country's eight major accounting firms have paid out over \$180 million in damages since 1980, and that the profession currently faces an estimated 2000 liability suits asking for over \$10 billion in damages [Ref. 4:p. 61].

These lawsuits are due primarily to auditors' failure to detect or report errors in corporate financial statements, so that investors and creditors made business decisions based on erroneous or misleading information. This problem became so acute in the early 1970s that two congressional investigations were initiated into the competency and regulation of the accounting profession. Thus, in order to avoid government intervention and regulation, auditors in the private sector are also developing standards, procedures

and evaluative methods designed to improve and ensure the quality and reliability of their audits.

B. PURPOSE, OBJECTIVES AND RESEARCH METHODOLOGY

The fundamental purpose of this thesis is to identify ways to enhance the quality of audit work performed by the Naval Audit Service. To this end, an in-depth examination is made of the public accounting profession's self-regulation initiatives, focusing on those quality elements that are also applicable to the Navy's internal auditing function. Finally, specific recommendations for the Naval Audit Service's quality program will be developed, based on the application of appropriate private sector practices.

The methodology for this research consisted principally of an exhaustive literature review on topics relating to audit quality, which included policy and procedural documents from both the public and private auditing communities, and numerous professional books, articles and studies. This documentation was augmented by personal interviews with key quality control specialists within a major public accounting firm, the General Accounting Office, the Department of Defense Inspector General's Office, and both the Naval and Army Audit Services.

In order to better understand the Naval Audit Service's operations and its present quality program, the researcher spent several days at the Service's Headquarters in Falls Church, Virginia, receiving orientation briefings and

conducting interviews. This was supplemented by a visit to one of the Service's regional offices, where interviews were held with Assistant Directors, Auditors-in-Charge, Lead Auditors, Auditors, and various regional staff personnel.

C. ORGANIZATION OF THE THESIS

Chapter I presented a brief introduction on the importance of quality audit work to both the public and private sectors. These objectives and research methodology were also disclosed.

Chapter II presents a discussion of the concept of quality, as it applies to the manufacturing and auditing functions. It provides fundamental definitions for quality, quality control and quality assurance, as well as discussing the components that go into each. It also briefly discusses the economics of quality control.

Chapters III and IV present the research findings on the private sector's audit quality initiatives. Chapter III outlines the development of auditing in the private sector, focusing on events and activities concerning quality control, while Chapter IV details the private sector's program for ensuring quality in their audit product.

Chapter V takes key ideas gleaned from the preceding research and applies them specifically to the Naval Audit Service. The chapter provides general management considerations for improving audit quality, as well as suggesting areas that warrant further research.

II. GENERAL COMMENTS ON THE NATURE OF QUALITY

A. INTRODUCTION

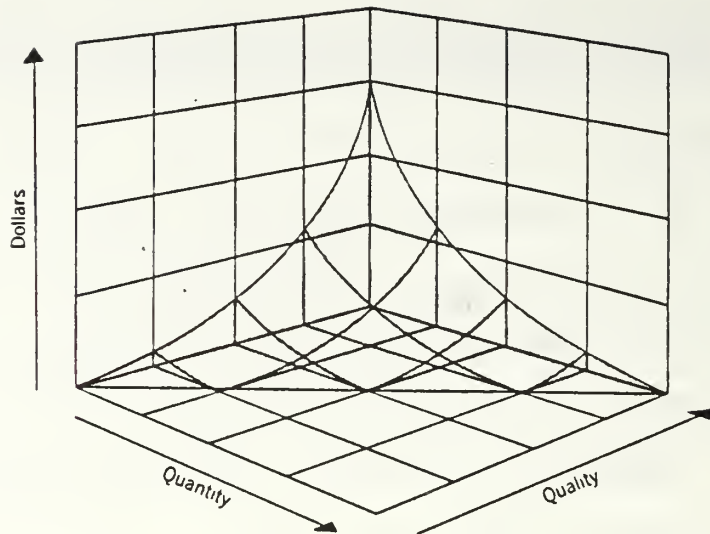
Quality is a somewhat difficult term to define by itself. It is actually a descriptive word, having true meaning only when used in relation to some standard or norm. This relationship is evident in the following dictionary definition: "degree of excellence; relative goodness; grade [underlining mine]." [Ref. 5:p. 595]

In the business sector, the general standard to which quality is related is customer satisfaction, since it leads to additional sales and, hence, additional profit. Indeed, one industrial definition states that quality is simply "the degree to which [the product] meets the requirements of the customer." [Ref. 6:p. 16]

This relationship between quality and customer demand is illustrated graphically in Figure 1. It adds quality as a third dimension to the traditional supply and demand function, showing that demand increases directly with quality. At any given price level, demand will be greatest at the point of highest quality. [Ref. 7:p. 180]

B. THE QUEST FOR QUALITY IN MANUFACTURING

Modern theory and techniques for quality control in manufacturing were started at the Hawthorne plant of the Western Electric Company in 1924. It was there that Dr. R.



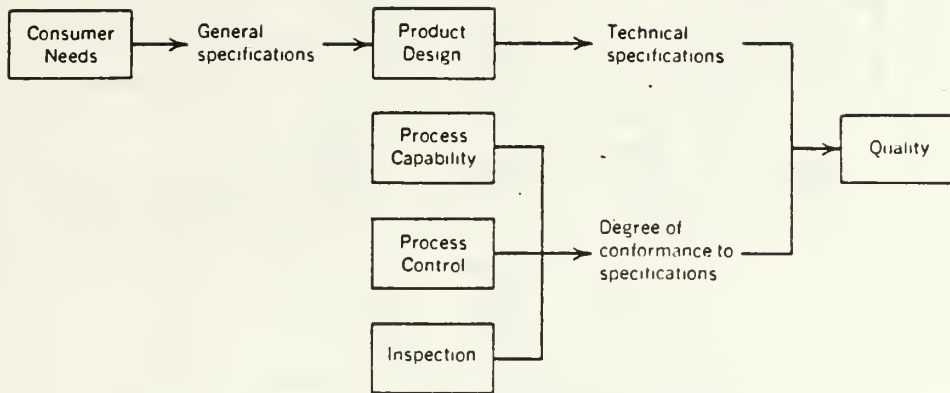
Source: D.L. Field, "Thoughts on the Economics of Quality," Industrial Quality Control, 178 (October 1966): 180, Fig. 3.

Figure 1. Demand Surface Including Quality

L. Jones of the Bell Telephone Laboratories first set up a Quality Assurance Department, whose basic tasking was:

- (a) To develop the theory of inspection, statistical methods, and new principles.
- (b) To develop methods of specifying the quality and establishing the economic standards of quality of telephone equipment.
- (c) To maintain oversight of the quality of outgoing goods.
- (d) To study the performance of equipment in service and to guide the steps taken to prevent recurrence of trouble. [Ref. 6:p. 27]

The quality function that evolved, illustrated in Figure 2, has two major components: quality of design and quality of conformance. Quality of design is achieved by developing

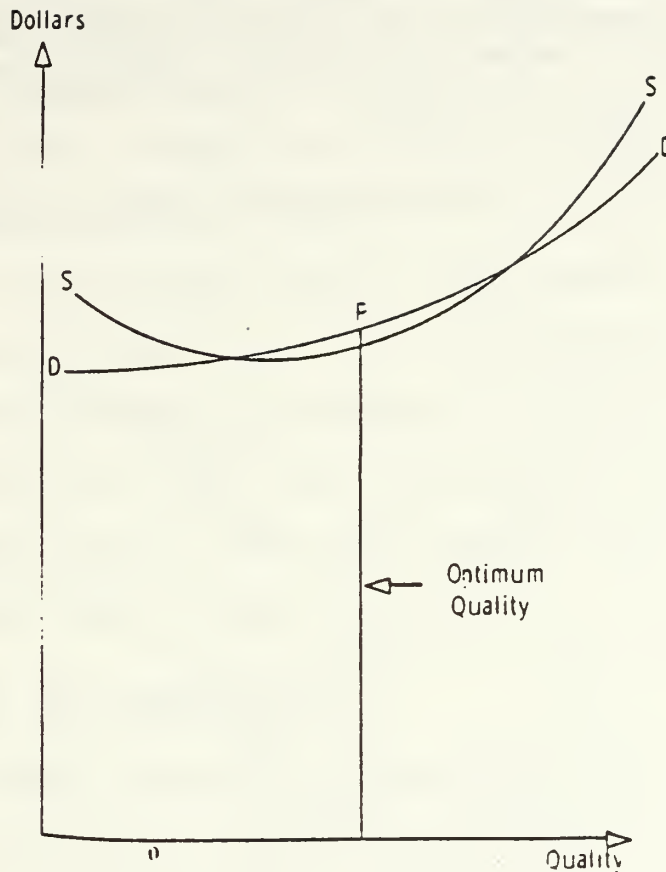


Source: E.G. Kirkpatrick, Quality Control for Managers and Engineers (New York: John Wiley & Sons, 1970): 5, Fig. 1.2.

Figure 2. Specifications and Quality

a product that meets consumer needs, including determination of the economic level of quality for each design characteristic. This design is then translated into technical specifications for production. Quality of conformance is accomplished by developing processes that assure conformance to the technical specifications, and thus achieve desired product quality.

Figure 3 illustrates the typical quality system in a manufacturing firm. It includes a subsystem of



Source: D.L. Field, "Thoughts on the Economics of Quality," Industrial Quality Control, 178 (October 1966): 181, Fig. 8.

Figure 4. Optimum Quality

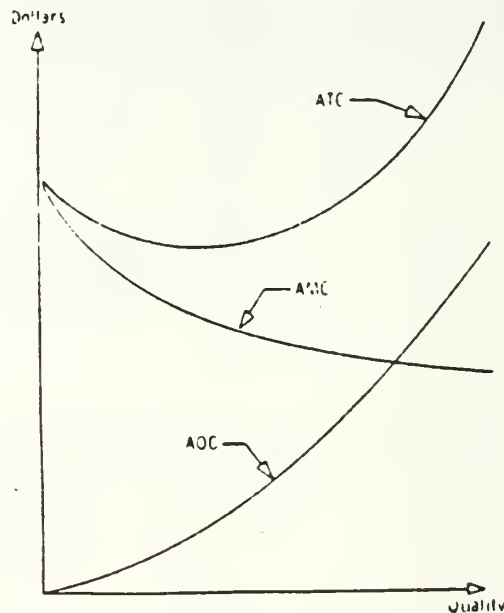
curve) most exceeds the average total cost (represented by the supply curve), thus maximizing profit. [Ref. 7:p. 181]

Defining quality costs as "those internal costs incurred in the achievement and demonstration of conformance to quality requirements," David L. Field further noted that:

average manufacturing costs decrease as average quality costs increase and the quality of the product improves.

. . . initial expenditures for quality improvement result in a sharp reduction of scrap and rework costs, but as these costs decline, a point of diminishing returns is reached, beyond which additional expenditures on quality do not bring a corresponding decrease in other manufacturing costs. [Ref. 7:p. 181]

This relationship is illustrated in Figure 5 below.



Source: D.L. Field, "Thoughts on the Economics of Quality," Industrial Quality Control, 178 (October 1966): 180, Fig. 5.

Figure 5. Quality Cost

One additional observation on the economics of quality deserves note. In private sector auditing, an investigative process is applied to corporate financial information. The auditor's subsequent opinion of the accuracy and reliability of that information is then used by investors and creditors in making financial decisions. The public accounting

profession thus has two groups of consumers: the firms who pay them to audit their financial statements, and the people who use those statements.

Each consumer group has its own demand curve for quality. Interestingly, however, the group who should logically have the higher quality requirements (the users) is not the group paying for the cost of that additional quality. This anomaly continues to raise considerable controversy over not only what the levels of audit quality should be, but also over who should set and monitor compliance with these levels.

C. QUALITY IN THE AUDIT PROCESS

The American Accounting Association set forth the accounting profession's standard definition of auditing in 1973:

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. [Ref. 8:p. 2]

This is more concisely stated as follows:

Auditing is a planned activity where the auditor identifies an engagement task, looks for evidence and then issues a report based on evaluation of the findings. [Ref. 9:p. 15]

The usefulness and credibility of the final output, the audit report, are a function of the level of quality maintained throughout the process.

As in manufacturing, quality in auditing is measured by the degree of conformance to standard practices and procedures. For the private sector, these standards are regulated by the accounting profession through procedural guidelines such as Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS); and by federal, state and local governments through the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS). Public sector auditing, which encompasses a much wider variety of organizations and audit objectives, is guided overall by the Comptroller General of the United States and the General Accounting Office.

Both the manufacturing industry and the auditing community view the process of quality conformance as a two-fold operation involving quality control and quality assurance. Indeed, the American Society for Quality Control's (ASQC) succinct definitions apply equally well to manufacturing and auditing:

Quality Control: The overall system of activities whose purpose is to provide a quality product or service that meets the needs of users; also the use of such a system. The aim of quality control is to provide quality that is satisfactory, adequate, dependable, and economic. The overall system involves integrating the quality aspects of several related steps including: the proper specification of what is wanted; production to meet the full intent of the specification; inspection to determine whether the resulting product or service is in accord with the specification; and review of usage to provide for revision of specification.

Quality Assurance: A system of activities whose purpose is to provide assurance that the overall quality control job is in fact being done effectively. The system

involves a continuing evaluation of the adequacy and effectiveness of the overall quality control program with a view to having corrective measures initiated where necessary. For a specific product or service, this involves specifications, audits, and the evaluation of the quality factors that affect the specification, production, inspection, and use of the product or service. [Ref. 6:p. 181]

The ASQC further distinguishes between these two functions by noting that "quality control has to do with making quality what it should be, and quality assurance has to do with making sure quality is what it should be." [Ref. 6:p. 182] The President's Council on Integrity and Efficiency made a similar distinction in their definition, promulgated in their Quality Standards for Federal Offices of Inspector General in January 1986:

Quality assurance is distinct from quality control. The latter is an inherent responsibility of line managers to ensure that their own units and personnel are performing work that will meet the above standards. Quality assurance, on the other hand, is an evaluative effort imposed and conducted by sources external to the units/personnel being reviewed to ensure that the overall work of the [Office of Inspector General] meets these standards. Thus, an audit supervisor ensuring that audit reports are properly referenced to workpapers is an example of quality control. An independent reviewer evaluating the referencing process is an example of quality assurance. [Ref. 10:p. 18]

As will be seen in Chapter IV, the private sector's quality program puts considerable emphasis on quality control, that is, on those elements that ensure quality is built into the product all through the process. Conversely, the public sector appears to be putting much of its current effort into quality assurance and oversight. It promotes both internal and external review of the audit process, and

relies heavily on supervision for quality control. It would be noted, however, that there is a direct relationship between quality control and quality assurance, for only by establishing and maintaining quality controls can audit quality be measured and assured.

III. AUDITING IN THE PRIVATE SECTOR

A. INTRODUCTION

Today's accounting industry includes 34,000 accounting firms with annual revenues of \$10 billion. These firms range from individual practitioners to the "Big Eight,"¹ who each have hundreds of partners in hundreds of offices around the world. Auditing represents about 60% of their workload, with the remainder spent on tax planning services (23%), management consulting work (16%), and other accounting and review services [Ref. 4:p. 61]

B. DEVELOPMENT OF AUDITING IN THE UNITED STATES

Professional accounting got its start in this country around 1880, when Scottish and English businessmen sent "chartered accountants" from the firms of Price Waterhouse and Peat, Marwick, Mitchell to watch over their investments in America's fledgling brewery and railroad industries. American accountants formed their first professional society, the American Institute of Accountants (predecessor of today's American Institute of Certified Public Accountants) in 1887, and there were 243 members by 1900 [Ref. 11:p. 10].

¹The "Big Eight" accounting firms are Arthur Anderson; Peat, Marwick, Mitchell; Ernst & Whinney; Coopers & Lybrand; Price Waterhouse; Arthur Young; Deloitte Haskins & Sells; and Touche Ross.

The number of practicing Certified Public Accountants (CPAs) grew rapidly after the turn of the century, spurred by both the country's industrial boom and the 1913 law instituting the first federal income tax. Robert H. Montgomery published the first wholly American auditing book, Auditing: Theory and Practice (later retitled Montgomery's Auditing) in 1912, and in 1917 the American Institute of Certified Public Accountants set forth its first auditing pronouncement, which dealt with the mechanics of auditing balance sheets.

The first U.S. company to voluntarily offer an accountant's certification with its securities was hat manufacturer John B. Stetson [Ref. 12:p. 5]. Following the stock market crash of 1929, however, auditing gained new significance. The 1933 and 1934 Federal Securities Acts led the New York Stock Exchange to require all its clients to provide audit certificates by independent CPAs. This brought new attention and definition to the accounting profession, as noted by an anonymous contributor to Fortune magazine in 1932:

Today it is no overstatement to say that there are preeminently three professions upon whose ethics as well as upon whose skill modern society depends: law, medicine, and Certified Public Accounting. . . . Upon the expert opinion of these abstract beings [CPAs]--who pit their judgment against the unbelievably subtle economic forces of this generation--the financial structure of our greatest industries is founded. [Ref. 12:p. 3]

The landmark fraud case at the McKeon & Robbins drug company in 1939, however, demonstrated that good intentions

were not sufficient. Although the head of the company was ultimately found to have swindled stockholders of millions of dollars, the Securities and Exchange Commission investigation reported that the auditors had indeed "conformed . . . to what was generally considered mandatory" in issuing their certification [Ref. 11:p. 10].

This lead to the first earnest efforts to regulate and standardize auditing. The American Institute of Certified Public Accountants (AICPA) promptly established the Committee on Auditing Procedure, whose charter was "to examine into auditing procedure and other related questions in the light of recent public discussion" [Ref. 13:p. 95]. They published the first of their 54 Statements on Auditing Procedure (SAPs) that same year.

Since World War II, accounting has increased in both volume and complexity, confounded by such factors as corporate mergers, international operations, pension fund liabilities and electronic data processing. In 1948, the membership of the AICPA formally adopted the 10 Generally Accepted Auditing Standards (GAAS) listed in Figure 6, which the Institute continues to augment with Statements on Auditing Standards (SAS). The first three standards concern the competence of auditors in general, and the remainder cover specific field work and reporting practices.

GENERALLY ACCEPTED AUDITING STANDARDS

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

4. The work is to be adequately planned and assistants, if any, are to be properly supervised.
5. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
6. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

7. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
8. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
9. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
10. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

Source: R.H. Montgomery, Montgomery's Auditing, 10th Ed. (New York: John Wiley & Sons, 1985), pp. 64-70

Figure 6. Generally Accepted Auditing Standards

Lawsuits in the 1960s and 1970s over fraud and misleading financial statements focussed renewed attention on the accounting profession. In 1962 the AICPA set up a practice review section to examine selected audit reports and inform individual practitioners of substandard work. This was complemented in 1971 by a local firm quality review program, but the focus of attention was still at the individual accountant level, emphasizing auditor competence and compliance with Generally Accepted Auditing Standards.

In response to congressional investigation, the AICPA agreed that quality was not solely a function of individual auditors, but also of audit management. Thus in 1977 the AICPA created the Division for CPA firms, to deal specifically with the operation and administration of accounting firms. The objectives of the section included the following:

1. Improve the quality of practice by CPA firms . . . through the establishment of practice requirements for member firms.
2. Establish and maintain an effective system of self-regulation of member firms by means of mandatory peer review, required maintenance of appropriate quality controls, and the imposition of sanctions for failure to meet membership requirements. [Ref. 14:p. 1-5]

C. PROFESSIONAL REGULATION

1. General

Public accounting is often likened to medicine and law because it is also a regulated profession. As such, it is controlled at three levels, described in Figure 7 below:

<u>Levels</u>	<u>Activities</u>
Private regulation by firms	Education Market discipline On line, real time supervision
Peer regulation by professional societies	Professional standards Education Organizational discipline
Public regulation by government	Permission to practice Civil litigation Investigation and punishment of violators of laws and regulations

Source: AICPA, Audit Quality: The Profession's Program (New York: AICPA, 1984): 6

Figure 7. Levels of Professional Regulation

2. Public Regulation

Public regulation by government is handled primarily by the state boards of public accountancy, who certify and license CPAs, and then monitor their professional conduct and continuing professional education. Only these state boards have authority over a CPA's license to practice.

Minimum requirements for obtaining a CPA license vary from state to state, but basically consist of formal education and experience, as well as successful completion of the CPA licensing examination. To maintain the CPA license, most states also require the accountant to complete a minimum amount of additional and refresher training annually.

3. Peer Regulation

Peer regulation is maintained by national, state and local professional organizations. This method of controlling quality, and thus improving professional credibility has been the motivation behind the establishment of most professional organizations. For example, the country's first legal society, the Association of the Bar of the City of New York, was founded in 1870 to counteract the ill effects of the Tweed ring [Ref. 15:p. 12].

In discussing the effectiveness of such regulation, Dr. Kenneth R. Austin noted two key concepts at work:

Under the concept of professional authority, the assumption is made that a profession knows what is best for itself because it has established its own norms and intrinsic moral values which it agrees to uphold. Under the monopoly concept, the assumption is made that the auditing profession can benefit society because it is driven by its social commitment to challenge itself and to expand the realm of its services. [Ref. 9:p. 18]

The leader for peer regulation in auditing is the American Institute of Certified Public Accountants (AICPA). As the national professional association for CPAs, it has over 231,000 members [Ref. 16:p. 4]. It was the AICPA who put forth the ten broad principles that comprise Generally Accepted Auditing Standards (GAAS), and it continues to update and amplify auditing procedures with its Statements on Auditing Standards.

The most fundamental way in which the AICPA regulates the accounting profession is through its Code of Ethics. The purpose of the Code is stated as follows:

Ordinarily those who depend upon a certified public accountant find it difficult to assess the quality of his services; they have a right to expect, however, that he is a person of competence and integrity. A man or woman who enters the profession of accountancy is assumed to accept an obligation to uphold its principles, to work for the increase of knowledge in the art and for the improvement of methods, and to abide by the profession's ethical and technical standards. [Ref. 17:p. 71]

The Code of Ethics has four sections: Concepts of Professional Ethics, Rules of Conduct, Interpretations of Rules of Conduct, and Ethics Rulings. The five major "Ethical Principles" put forth by the Code are:

Independence, integrity and objectivity. A certified public accountant should maintain his integrity and objectivity and, when engaged in the practice of public accounting, be independent of those he serves.

General and technical standards. A certified public accountant should observe the profession's general and technical standards and strive continually to improve his competence and the quality of his services.

Responsibilities to clients. A certified public accountant should be fair and candid with his clients and serve them to the best of his ability, with professional concern for their best interests, consistent with his responsibilities to the public.

Responsibilities to colleagues. A certified public accountant should conduct himself in a manner which will promote cooperation and good relations among members of the profession.

Other responsibilities and practices. A certified public accountant should conduct himself in a manner which will enhance the stature of the profession and its ability to serve the public. [Ref. 17:p. 73]

Having developed this personal philosophy for conduct and performance, the AICPA's boards and committees continue to formulate standards and procedures concerning specific activities of the profession. Three of these

groups have had direct impact on audit quality: the Auditing Standards Board, the Quality Control Standards Board, and the Public Oversight Board.

The Auditing Standards Board is concerned primarily with auditor qualifications, auditing procedures, audit performance and reporting requirements. Their principal output is the Statements on Auditing Standards (SASs), which follow after the Statements on Auditing Procedure (SAPs) issued by their predecessor, the Committee on Auditing Procedure.

Established in 1977 and disbanded in 1983, the Quality Control Standards Board was set up in response to the SEC investigations for Congress. The board's specific tasking was to promulgate guidance on improving audit quality by ensuring conformance to auditing standards. Their principal product was the Statement on Quality Control Standards (SQCS) No. 1, discussed below.

Although the Public Oversight Board is involved only with the SEC Practice Section of the Division for CPA Firms, its role as external oversight and liaison with the SEC has given it great weight. Membership is drawn "from among prominent individuals of high integrity and reputation" [Ref. 18:p. 7], which includes not only accountants, but also public officials, lawyers, bankers and security industry executives.

4. Private Regulation

The third level of professional regulation is that provided by the policies and procedures of individual accounting firms. The depth of these will be contingent on such items as the firm's size, its organizations, the autonomy given individual audit offices or audit teams, the nature of the practice, etc. This form of regulation is specifically addressed by the profession's Peer Review program, discussed in Chapter IV.

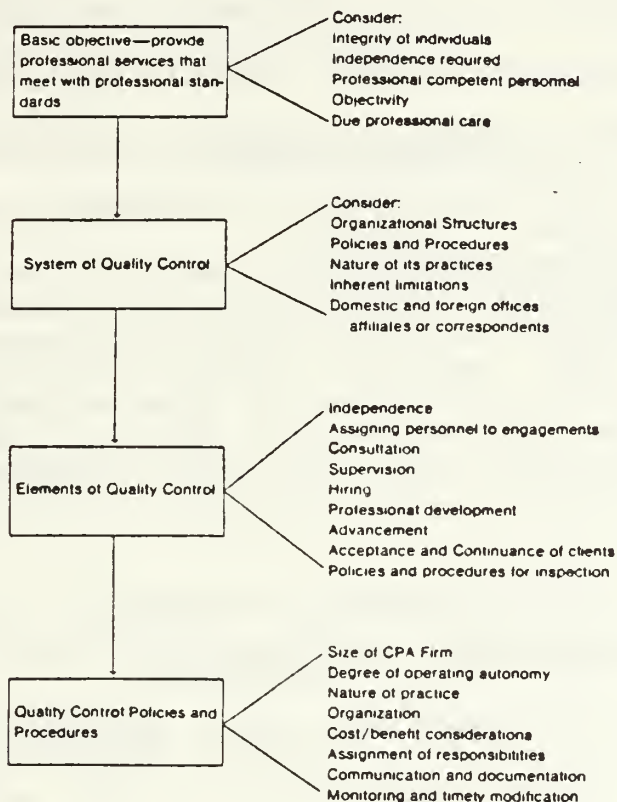
D. KEY PRONOUNCEMENTS GOVERNING AUDIT QUALITY

1. AICPA Pronouncements

The AICPA published numerous documents in the 1970's, as they developed and fine-tuned audit quality standards and procedures. The first real pronouncement on audit quality control was the Statement on Auditing Standards (SAS) No. 4, Quality Control Considerations for a Firm of Independent Auditors, issued in 1974. This was followed by the Voluntary Quality Control Review Program for CPA Firms, together with guidelines on how to implement this program, in 1976.

When the Quality Control Standards Committee was established in 1979, however, they issued the Statement on Quality Control Standards (SQCS) No. 1, which superceded SAS No. 4 and is still the prevailing regulation on the subject. SQCS No. 1, which appears as Appendix A and will be discussed in detail in Chapter IV, sets forth the quality

control program outlined in Figure 8. This includes nine fundamental elements of quality control that have become the cornerstone of audit quality in the private sector:



Source: J.C. Lambert, "Charting Quality Control Standards," CPA Journal 50 (January 1980): 86.

Figure 8. Quality Control for a CPA Firm

- Independence
- Assigning Personnel to Engagements
- Consultation
- Supervision
- Hiring

- Professional Development
- Advancement
- Acceptance and Continuance of Clients
- Inspection.

Once SQCS No. 1 was formalized, the AICPA issued the Statement on Auditing Standards No. 25, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards. The basic relationship is summed up as follows:

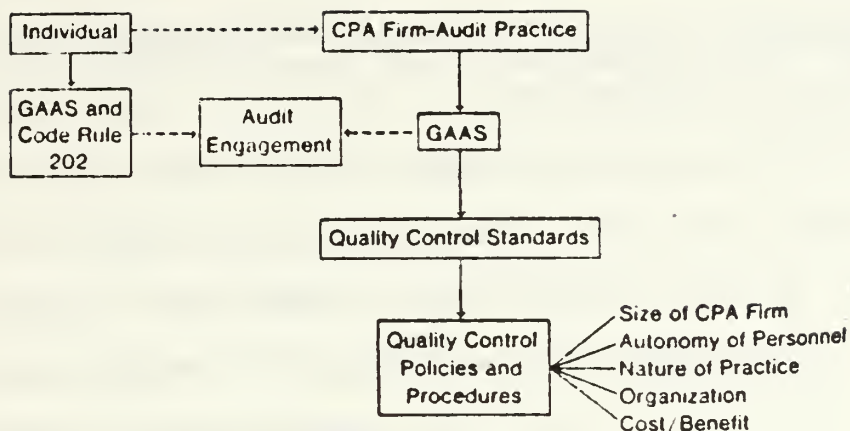
Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, generally accepted auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole. [Ref. 17:p. 97]

This relationship is diagrammed in Figure 9.

2. Other Professional Pronouncements

It should be noted here that although the AICPA is the leader for auditing regulation in this country, it is not alone in its work on audit quality. The International Federation of Accountants (IFAC), for one, published a quality control document similar to SQSC No. 1 in 1981, under the direction of its International Auditing Practices Committee. Titled Control of the Quality of Audit Work, and issued as International Auditing Guideline 7, the document's purpose is to provide guidance as to:

- the procedures to be followed by the auditor to comply with [Basic Principles Governing an Audit, International Auditing Guideline 3] as it relates to the work delegated to assistants on an individual audit, and



Source: J.C. Lambert, "Charting Quality Control Standards," CPA Journal 50 (January 1980): 84.

Figure 9. Relationship of GAAS to Quality Control Standards

- the policies and procedures to be adopted by an audit firm to provide reasonable assurance regarding the quality of audit work generally. [Ref. 19:p. 1]

The guidelines themselves, presented in their entirety as Appendix B, cover Personal Qualities, Skills and Competence, Assignment, Direction and Supervision, Acceptance and Continuance of Clients, and Inspection.

The guidelines published by the Nederlands Instituut van Registeraccountants (NIVRA), included as Appendix C, were issued in 1979. They consist of:

- A. Recommendations regarding the execution of audit assignments in general
- B. Recommendations regarding the execution of individual assignments
- C. Recommendations concerning the professional development and prerequisites of partners and staff involved in audit assignments.

Another professional association to issue a pronouncement on audit quality is the Auditing Practices Committee of the Consultative Committee of Accountancy Bodies. This auspicious British organization is comprised of the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland, the Institute of Chartered Accountants in Ireland, the Association of Certified Accountants, and the Institute of Cost and Management Accountants.

Their auditing guideline titled simply Quality Control was issued in 1985. Besides emphasizing compliance with approved auditing standards, it states that:

Quality control procedures should also promote observance of the personal standards relevant to the work of an auditor that are described in the ethical guides published by the accountancy bodies. [Ref. 20:p. 86]

Quality Control--Ensuring and Improving the Quality of Audits (Auditing Statement No. 6) was promulgated by the Union Europeene des Experts Comptables Economiques et Financiers (UEC) in 1979. This document also distinguishes between measures related to the practice in general and measures related to procedures of individual audits. It does state, however, that:

Quality control measures should extend to all aspects of the organization of the audit practice since the quality of audits is influenced either directly or indirectly by the overall organization of the practice and procedures. [Ref. 21:p. 109]

One additional quality control pronouncement deserves note here. It is Standard 506, Quality Assurance, of the Standards for the Professional Practice of Internal Auditing, published by the Institute of Internal Auditors in 1978. Standard 506 tasks the director of an internal auditing department to establish and maintain a quality assurance program as follows:

- .01 The purpose of this program is to provide reasonable assurance that audit work conforms with the Standards, the internal auditing department's charter, and other applicable standards. A quality assurance program should include the following elements:
 - .1 Supervision
 - .2 Internal reviews
 - .3 External reviews

[Ref. 22:p. 500-3]

IV. THE PRIVATE SECTOR'S PROGRAM FOR AUDIT QUALITY

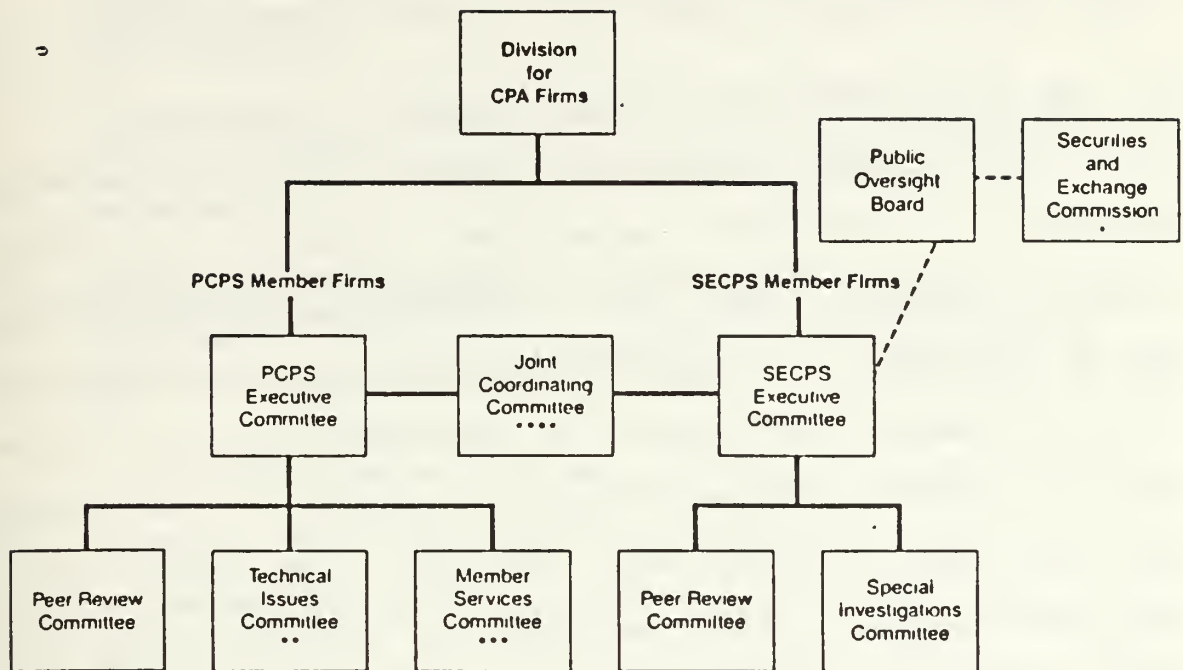
A. THE DIVISION FOR CPA FIRMS

The AICPA established the Division for CPA Firms in September of 1977 in response to public and congressional outcry for regulation of the accounting profession. This division, illustrated in Figure 10, consists of the Private Companies Practice Section (PCPS) and the SEC Practice Section (SECPS). Membership in either section is voluntary.

While each section has its own membership requirements, they are very similar. These specify such items as minimum required levels of continuing professional education and liability insurance. Both sections require adherence to AICPA quality control standards and both require member firms to undergo peer review every three years. Indeed, while all firms are expected to establish quality control systems, only members of the Division for CPA Firms, or firms in a state where it is required by the state board of accountancy, are required to do so.

The following sanctions may be levied by the AICPA if a member firm does not maintain compliance with membership requirements:

- (a) Require corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel.
- (b) Additional requirements for continuing professional education.



The SEC has oversight of the profession in general. The Public Oversight Board generally serves as a liaison between the Securities and Exchange Commission and the SEC Practice Section and coordinates access by the SEC to selected peer review and Board workpapers.

- ** The Technical Issues Committee monitors AICPA technical committees and develops recommendations to these groups from the perspective of accountants who serve private companies.
- *** The Member Services Committee develops and administers a program of PCPS member services.
- **** The Joint Coordinating Committee was recently formed to facilitate coordination between the two sections in identifying and dealing with common problems.

Source: American Institute of Certified Public Accountants, Audit Quality: The Profession's Program (New York: American Institute of Certified Public Accountants, 1984): p. 7.

Figure 10. Organization of the Division for CPA Firms

- (c) Accelerated or special peer reviews.
- (d) Admonishments, censures, or reprimands.
- (e) Monetary fines.

(f) Suspension from membership.

(g) Expulsion from membership. [Ref. 14:pp. 1-15]

B. THE NINE ELEMENTS OF QUALITY CONTROL

In 1979 the newly-formed Quality Control Standards Committee of the AICPA promulgated Statement on Quality Control Standards (SQCS) No. 1, System of Quality Control for a CPA Firm. It specifically identified nine quality control elements that should be considered in the development of a firm's program of quality control. It also noted that the elements themselves, discussed individually below, are interrelated. Thus the standards set for hiring will impact training requirements, which in turn affect advancement, and so forth.

1. Independence

The private sector audit function provides an independent, external evaluation of corporate financial data. The primary users of this evaluation are stockholders, who rely on it to make investment decisions and creditors, who rely on it to make loan decisions. It is both a legal and an ethical requirement, therefore, that the auditor be free from any bias or undue pressure, in order that he has "an ability to view problems and opportunities both objectively and independently" [Ref. 23:p. 77].

Auditing theory divides independence into three parts:

- 1) Programming Independence--Freedom from control or undue influence in the selection of audit techniques and procedures and in the extent of their applications.
- 2) Investigative Independence--Freedom from control or undue influence in the selection of areas, activities, personal relationships, and managerial policies to be examined.
- 3) Reporting Independence--Freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination. [Ref. 24:p. 6]

Although independence may partly be a state of mind, the Statement on Quality Control Standards (SQCS) No. 1 requires accounting firms to establish policies and procedures that "provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rule of conduct of the AICPA" [Ref. 25:p. 3]. The four objectives for these policies, together with suggestions for their implementation, are listed below:

1. Require that personnel at all organizational levels adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, state CPA society, state board of accountancy, state statute, and, if applicable, the Securities and Exchange Commission and other regulatory agencies.
2. Communicate policies and procedures relating to independence to personnel at all organizational levels.
 - a. Inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures.
 - b. Emphasize independence of mental attitude in training programs and in supervision and review of engagements.

- c. Apprise personnel on a timely basis of those entities to which independence policies apply.
 - d. Maintain a library or other facility containing professional, regulatory, and firm literature relating to independence matters.
- 3. Conform, when acting as principal auditor, the independence of another firm engaged to perform segments of an engagement.
 - 4. Monitor compliance with policies and procedures relating to independence.
 - a. Obtain from personnel periodic, written representations, normally on an annual basis, stating that--
 - (i) They are familiar with the firm's independence policies and procedures.
 - (ii) Prohibited investments are not held and were not held during the period.
 - (iii) Prohibited relationships do not exist, and transactions prohibited by firm policy have not occurred.
 - b. Assign responsibility for resolving exceptions to a person or group with appropriate authority.
 - c. Assign responsibility for obtaining representations and reviewing independence compliance files for completeness to a person or group with appropriate authority.
 - d. Review periodically accounts receivable from clients to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence. [Ref. 26:pp. 8-11]

In addition to financial independence, Lennis M. Knighton recommends the following considerations for truly unbiased judgment:

- The auditor must have no conflicts of interest
- The auditor must have unlimited access to information

- The auditor must control selection and development of staff
- The auditor must control the content of the audit report
- The auditor's budget for the audit must "in no way be contingent upon the amount of 'savings' resulting from audit effort, nor should the budget be subject to reduction as punishment for adverse findings
- The auditor must have no responsibility for enforcement of audit recommendations. [Ref. 24:p. 7]

2. Assignment of Personnel to Engagements

The second element of quality relates to the way in which management utilizes its personnel. SQCS No. 1 specifies the following:

Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision. [Ref. 25:p. 3]

The objective, then, is to establish assignment policies that create audit teams capable of effectively and efficiently meeting audit requirements, while still considering staff development. These assignment policies must consider the following factors in order to balance audit manpower requirements, personal skills, and individual development:

- (i) Audit size and complexity.
- (ii) Personnel availability.
- (iii) Special expertise required.

- (iv) Timing of the work to be performed.
- (v) Continuity and periodic rotation of personnel.
- (vi) Opportunities for on-the-job training. [Ref. 19:p. 6]

3. Consultation

Auditors pride themselves on being generalists, able to apply their investigative skills to virtually any auditing situation. Yet a number of areas have become either too complex or too evolutionary for the average auditor to keep up with. These areas include such things as multinational operations, federal tax laws, and computers, and there are auditors who specialize in them. The Defense Contract Audit Agency, for example, employs auditors extensively trained in such subjects as system acquisition, contract law and cost accounting. Another example is the recently established designation for Certified Data Processing Auditor (CDPA) [Ref. 27:p. 26].

The quality objective for consultation is to ensure that "personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority" [Ref. 25:p. 3]. This requires policies that not only identify specialized areas and appropriate sources of information, but also address when and how these sources are to be used. The following sample procedures show primary considerations on consultation:

- State the areas or specialized situations that require consultation because of the nature or complexity of the subject matter.
- State by whom and how the consultation process is initiated.
- Specify that certain specialists are to serve as authoritative sources for consultation.
- Maintain consultation agreements with other firms or persons, as necessary to supplement the firm's resources.
- Advise personnel of the authority of specialists and the procedure for resolving differences of opinion.
- State the conditions that require documentation and the extent required.
- Maintain and provide access to adequate reference libraries and other authoritative sources.
- Establish and maintain a research or technical inquiry function to assist personnel with practice problems.
- Maintain subject files containing the results of consultations for reference and research purposes. [Ref. 23:p. 81-2]

4. Supervision

Morley P. Carscallen, in his recent article on audit efficiency, used the following example to stress the importance of supervision:

If someone hired a contractor to build a house on a cost plus basis, they'd get pretty alarmed if they discovered that the job was being planned and executed by an apprentice carpenter with the contractor coming along at the end to look things over. . . . [Ref. 28:p. 22]

Simply stated, supervision encompasses those steps taken to ensure "that the work performed meets the firm's standards of quality" [Ref. 25:p. 3]. While this seems the most logical place to focus quality control efforts, since

it impacts virtually all aspects of the audit process, studies show it is actually a key problem area. One recent survey of peer review recipients, for example, found supervision to be the most frequently cited weakness, accounting for 60.3% of the deficiencies noted [Ref. 29:p. 28].

Quality control literature distinguishes between those procedures that maintain the firm's standards overall, and those procedures employed in managing a specific audit engagement. The former covers work standards and review procedures that include the following:

- Provide adequate supervision at all organizational levels, considering the training, ability, and experience of the personnel assigned.
- Develop guidelines for the form and content of working papers.
- Utilize standardized forms, checklists, and questionnaires to the extent appropriate to assist in the performance of engagements.
- Provide procedures for resolving differences of professional judgment among members of an engagement team.
- Develop guidelines for review of working papers and for documentation of the review process.
- Develop guidelines for review of the report to be issued for an engagement. [Ref. 26:p. 15]

Supervision of the individual audit engagement should include aspects of both direction and review, as evident in the following sample tasking:

Personnel carrying out supervisory responsibilities should perform the following functions during the performance of an audit:

- a) Monitor the progress of the work to determine that:

- assistants appear to have the necessary skills and competence to carry out their assigned tasks;
 - assistants appear to understand the audit directions; and
 - the work is being carried out in accordance with the audit program and other planning documents.
- b) Become informed of significant accounting and auditing questions raised during the audit, assess their significance, and modify the audit program where appropriate.
- c) Resolve differences between personnel. [Ref. 19:p. 2]

5. Hiring

The AICPA states that "the quality of a firm's work ultimately depends on the integrity, competence, and motivation of personnel who perform and who supervise the performance of the firm's services" [Ref. 18:p. 12]. One way to control the quality of the work, then, is to control the quality of the people hired to do it.

The first step to an effective hiring program is to establish hiring objectives and staffing needs. This involves performing the following:

- a. Plan for the firm's personnel needs at all levels and establish quantified hiring objectives based on current clientele, anticipated growth, and retirement.
- b. Design a program to achieve hiring objectives which provides for--
 - (i) Identification of sources of potential hirees.
 - (ii) Methods of contact with potential hirees.
 - (iii) Methods of specific identification of potential hirees.
 - (iv) Methods of attracting potential hirees and informing them about the firm.

- (v) Methods of evaluating and selecting potential hirees for extension of employment offers.
- c. Inform those persons involved in hiring as to the firm's personnel needs and hiring objectives.
- d. Assign to authorized persons the responsibility for employment decisions.
- e. Monitor the effectiveness of the recruiting program.
[Ref. 19:p. 3]

The second step in the hiring program is the establishment of employee standards, and procedures for evaluating potential employees against these standards. Specific tasks to this end include:

- a. Identify the attributes to be sought in hirees, such as intelligence, integrity, honesty, motivation and aptitude for the profession.
- b. Identify achievements and experiences desirable for entry level and experienced personnel. For example:
 - (i) Academic background.
 - (ii) Personal achievements.
 - (iii) Work experience.
 - (iv) Personal interests.
- c. Set guidelines to be followed when hiring individuals in situations such as--
 - (i) Hiring relatives of personnel or relatives of clients.
 - (ii) Rehiring former employees.
 - (iii) Hiring client employees.
- d. Obtain background information and documentation of qualifications of applicants by appropriate means, such as--
 - (i) Resumes.
 - (ii) Application forms.

(iii) Interviews.

(iv) Academic record.

(v) Personal references.

(vi) Former employment references.

- e. Evaluate the qualifications of new personnel, including those obtained from other than the usual hiring channels (for example, those joining the firm at supervisory levels or through merger or acquisition), to determine that they meet the firm's requirements and standards. [Ref. 19:pp. 3-4]

Finally, the hiring program should clearly designate those persons with the authority to make hiring decisions.

6. Professional Development

Once quality, motivated personnel have been hired, the firm must foster and maintain their competence, which the American Accounting Association states "is a product of education and experience as well as continued development of the individual and his profession" [Ref. 8:p. 17]. To gain audit quality through professional development, however, requires a dynamic, well-organized and visibly supported training program that includes functional training of junior auditors, continuing education of more senior auditors, and specialization. As an example, Figure 11 outlines one auditing department's determination of training requirements.

Functional training is essential to maximize productivity of junior staff members. Formal auditing education deals principally with theory and is not geared towards

STAFF AUDITORS	SENIOR AUDITORS	SUPERVISORS	MANAGERS	DIRECTOR
Job Functions/Standards Technical Training Orientation Initial O-J-T Advanced O-J-T Audit Concepts Work-paper Preparation Writing Skills Interpersonal Communication Skills Investigative Interviewing Performance Appraisal System Specialized Auditing	Job Functions/Standards Management Concepts — Basic Budgeting	Job Functions/Standards Compensation Guide Selection Interviewing Performance Appraisal Interviewing Career Planning Grid Point-of-Sale Workshop Management Concepts — Advanced	Job Functions/Standards Effective Presentations	Job Functions/Standards Management Concepts — Executive Executive Presentations

Source: R.C. Rainey, "Setting Up Management Training and Development for the Audit Department," Internal Auditor, 35 (August 1978): 70

Figure 11. Core Training Activities by Position

practical application, which is thought to be the purview of the audit firm. Indeed, when a recent survey asked auditing professors what emphasis they gave to Statements on Auditing Standards, design of audit procedures, and work paper techniques, two out of three professors did not view any of these subjects as critical to their auditing courses. [Ref. 30:p. 10]

Junior auditors are not alone in their need for training, however. Experienced auditors need continuing education to keep abreast of the dynamic field of auditing, which might include new areas of practice, changes in auditing philosophy, new audit techniques, or new professional regulations. Additional training is also important to prepare staff members for advancement. Finally, occasional across-the-board training can ensure continuity of practice throughout the firm, as well as boost morale and team spirit.

Training can be accomplished in a number of ways, including attendance at outside courses and professional seminars, development of internal courses, administration of correspondence courses, and on-the-job training. The formulation and presentation of courses internally is especially productive, since it provides an opportunity to develop both the participants and the instructor. Care must be taken, however, that course content and format are reviewed by competent authority, course prerequisites and objectives are

clearly stated, and instructors have been trained in course presentation.

Regardless of the amount of course work available, the key to auditor development remains on-the-job training, where technical skills and professional judgment are applied. Therefore, the firm's training policies must ensure that training needs are considered in job assignment, so as to provide work "which broadens experience, challenges the individual, prepares the individual for more advanced training and assignment, and increases knowledge in a variety of businesses" [Ref. 31:p. 15].

Further considerations for a sound professional development program are included in Appendix D, which is a checklist for reviewing a firm's training program. One additional element deserves special note, however: Visible support by management is critical to the success of any program. This includes hiring qualified personnel to design and administer the program, providing both time and funding to carry it out, and recognizing professional development in evaluations and advancement decisions.

7. Advancement

The element of advancement seeks to ensure that "those selected for advancement will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume" [Ref. 25:p. 4]. These

qualifications include character, intelligence, judgment and motivation.

The first step in developing procedures for advancement is to define the qualifications necessary for each position in the firm. This might include consideration of the following:

- (i) Technical knowledge.
- (ii) Analytical and judgmental abilities.
- (iii) Communicative skills.
- (iv) Leadership and training skills.
- (v) Client relations.
- (vi) Personal attitude and professional bearing.
- (vii) Possession of a CPA certificate for advancement to a supervisory position. [Ref. 26:p. 22]

The firm must then establish a means of evaluating personnel in the areas critical to advancement. This includes periodic counselling and corrective action for career progression. Representative procedures include:

- Identify evaluation responsibilities and requirements at each level indicating who will prepare evaluations and when they will be prepared.
- Instruct personnel on the objectives of personnel evaluation.
- Utilize forms, which may be standardized, for evaluating performance of personnel.
- Require that evaluations be reviewed by the evaluator's superior.
- Review periodically with personnel the evaluation of their performance, including an assessment of their progress with the firm.

- Evaluate partners periodically by means of counselling, peer evaluations, or self appraisal, as appropriate, regarding whether they continue to have the qualifications to fulfill their responsibilities.
- Review periodically the system of personnel evaluation and counseling to ascertain that--
 - Procedures for evaluations and documentation are being followed on a timely basis.
 - Requirements established for advancement are being achieved.
 - Personnel decisions are consistent with evaluations.
 - Recognition is given to outstanding performance. [Ref. 26:p. 23]

Finally, the firm must establish responsibility for making advancement decisions. Designated persons should not only administer firm policies on advancement and termination, but should study these policies periodically to ensure that they are developing the appropriate cohesiveness between personnel qualifications and job responsibilities.

8. Acceptance and Continuance of Clients

Procedures governing the acceptance and continuance of clients should "minimize the likelihood of association with a client whose management lacks integrity" [Ref. 25:p. 4]. The statement is quick to add, however, that these are internal procedures only, and that their use

. . . does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection, or retention of clients. [Ref. 25:p. 4]

9. Inspection

The function of the final element, inspection, is

simply "to provide the firm with reasonable assurance that the procedures relating to the other elements of quality control are being effectively applied" [Ref. 25:p. 4]. This internal review is designed by and for management, and is not a substitute for the more exhaustive external reviews discussed in the next section.

While it appears logical to periodically review any program's implementation and effectiveness, it has been noted that "in-house inspections are often neglected or delayed since they result in non-billable time and cause us to be critical of our own work" [Ref. 32:p. 33]. Nonetheless, a firm should fully inspect its quality control system at least annually, focusing on the following:

- Review and test compliance with applicable quality control policies and procedures.
- Review selected engagements for compliance with professional standards and with the firm's quality control policies and procedures.

Furthermore, the firm's inspection procedures must also specify the methods for reporting inspection findings to appropriate management levels and for monitoring corrective actions taken.

C. PEER REVIEW

1. Background

Professional accountants first formally reviewed each other's work as part of a joint program initiated in 1920 between the American Institute of Accountants (AIA,

predecessor of the AICPA) and Robert Morris Associates, a banking group. Under this program, bankers could submit questionable financial statements and auditors' reports to an AIA committee for review and discussion. Comments from the committee were then published in Robert Morris' bulletin. [Ref. 33:p. 6]

It was not until 1962, however, that the AICPA began reviewing audit work to better the profession. The Practice Review Committee, founded that year as part of the Practice Review Program, reviewed allegedly substandard audit work submitted to them by bankers or accountants. The committee's findings, however, were sent only to the auditor who had performed the work. No report went back to those who submitted the items, nor did the AICPA take any formal action against the auditor.

The AICPA complemented the Practice Review Program, which was geared toward individual auditors, with the Local Firm Quality Review Program in 1971. This program also had a provision for reviewing auditors' work, but the reviews were voluntary and provided only verbal feedback. Nonetheless, the objectives of this program were direct precursors to today's peer review program:

1. To review the overall audit practice of a CPA firm.
2. To review completed engagements for evidence of technical competence, fairness of financial statements' presentation and reasonableness of the auditor's opinion. [Ref. 33:p. 6]

The current Peer Review Program got its formal start at the inception of the Division for CPA Firms in 1977. The 1978-79 Annual Report of the Public Oversight Board stated the objectives of the program as follows:

The objectives of a peer review are to determine whether a reviewed firm's system of quality control for its accounting and auditing practice is appropriately comprehensive and suitably designed for the firm, whether quality control policies and procedures are adequately documented and communicated to professional personnel, and whether they are being complied with so as to provide the firm with reasonable assurance of conforming with professional standards and the membership requirements of the section. [Ref. 34:p. 6]

The Peer Review Manual, promulgated in 1981, specifies three actions necessary to meet those objectives:

1. Study and evaluation of a reviewed firm's quality control system.
2. Review for compliance with a reviewed firm's quality control policies and procedures by--
 - Review at each organizational or functional level within the firm.
 - Review of selected engagement working paper files and reports.
3. Review for compliance with membership requirements of the section. [Ref. 14:p. 2-7]

2. The Process

Peer review begins with the assignment of the peer review team. This is usually done by the Peer Review Committee or by another approved agency, such as a state board of public accountancy. A firm may make arrangements directly with another member firm, however, if it is not a reciprocal review.

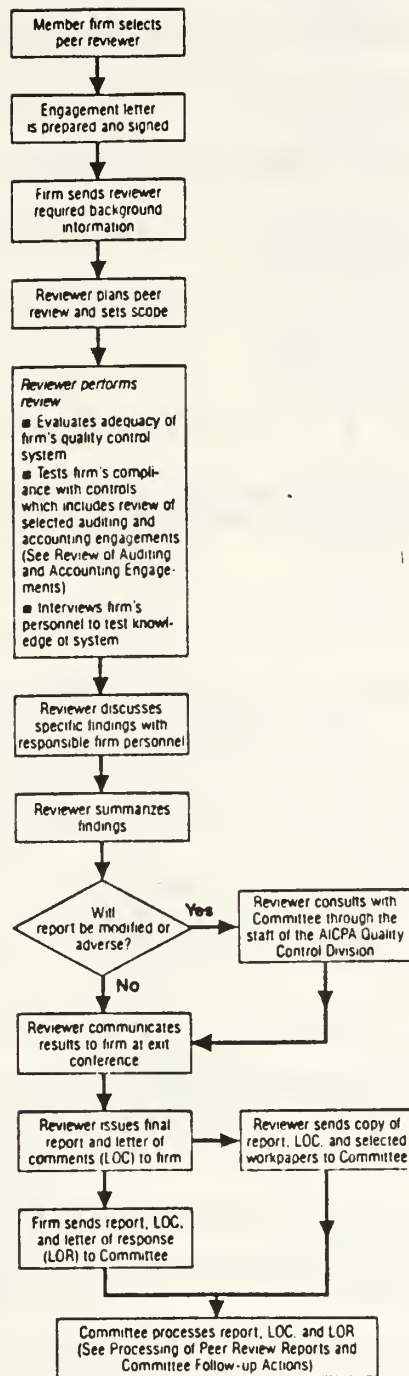
The peer review process consists of two distinct reviews: the functional review and the engagement review. The amount of emphasis placed on each depends on the size of the firm being reviewed.

The functional review, illustrated in Figure 12, evaluates the firm's system of quality control, focussing on the nine elements of quality control promulgated in SQCS No. 1. The objectives are to determine whether the quality control system is appropriate for the firm and whether it is working properly. This review is very similar to the test of internal controls done in an audit, and it uses familiar techniques such as questionnaires, interviews, flowcharts, etc.

The management review, illustrated in Figure 13, examines a sample of work completed by the firm, usually representing 5-10% of the total manhours expended. The peer review team examines the reports and supporting workpapers for those engagements identified. Several checklists developed by the AICPA aid the reviewers in this effort.

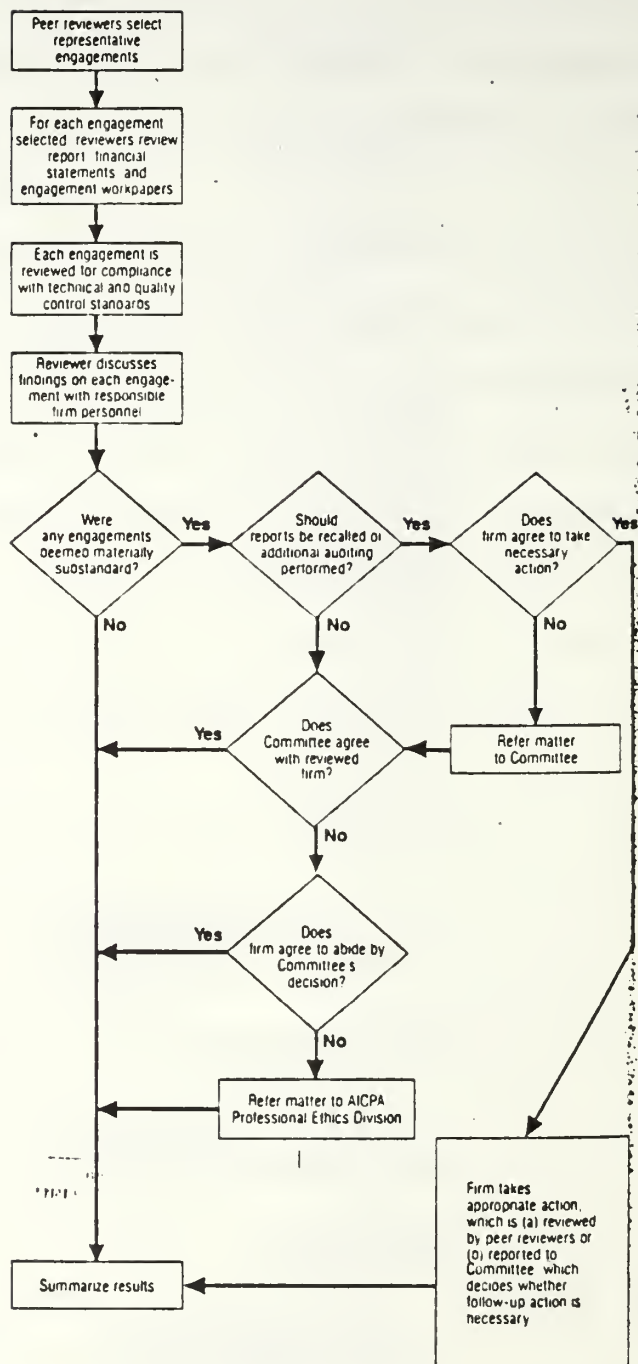
At the end of the peer review, the review team prepares a formal report in one of the following categories:

- 1) Unqualified--no deficiencies noted
- 2) Qualified --some deficiencies, but system as a whole is appropriate and reliable
- 3) Disclaimer--insufficient evidence available to make a determination
- 4) Adverse--system is inappropriate or is not working well enough to bolster quality control



Source: American Institute of Certified Public Accountants, Audit Quality: The Profession's Program (New York: American Institute of Certified Public Accountants, 1984): 16

Figure 12. Review of Firm's Quality Control System



Source: American Institute of Certified Public Accountants, Audit Quality: The Profession's Program (New York: American Institute of Certified Public Accountants, 1984): 16.

Figure 13. Review of Auditing and Accounting Engagements

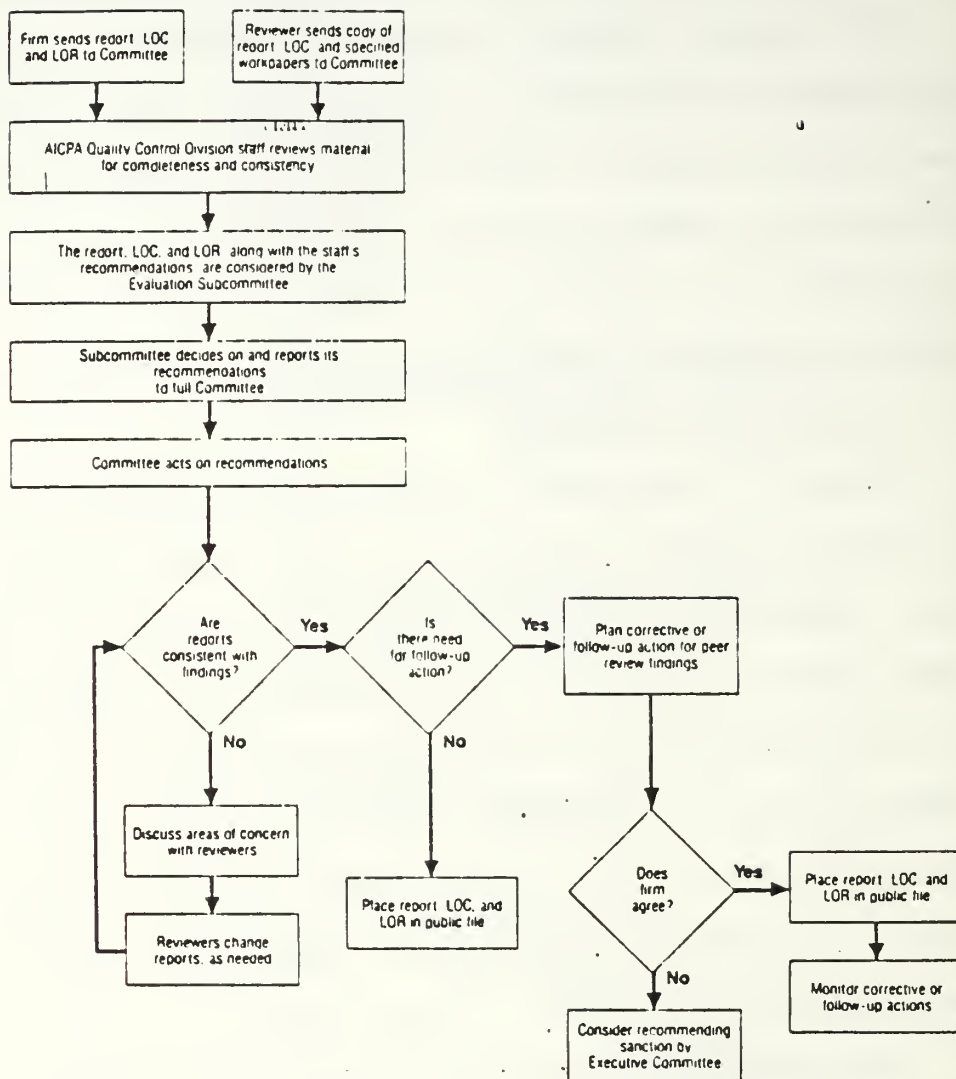
The team will also provide the firm with a Letter of Comment, if appropriate, outlining corrective actions needed. The firm may then add a Letter of Response to the report.

The report, letter of comment and letter of response are processed as outlined in Figure 14. All three will eventually to be put on file at the AICPA, where they will be available for public review. Additionally, for a limited time following the review of an SEC Practice Section firm, the SEC may review the peer review team's working papers.

3. Peer Review Findings

Several independent studies were conducted in the early 1980s to assess the results of the first round of peer reviews. Kenneth R. Austin reviewed the public files for all peer reviews completed from September 1977 through July 1983. He found that 1264 peer reviews had been accepted by the AICPA (792 in the PCPS and 472 in the SECPS). He further noted that 87% of the firms received unqualified reports, 11% received Qualified or Disclaimer reports, and 2% received adverse reports. [Ref. 9:p. 19]

Austin's review found that most deficiencies were in four areas: the quality control elements of supervision and inspection, and the membership requirements for continuing professional education and insurance. These findings were consistent with a survey conducted by Joseph A. DeFatta and Julian D. Smith, who sent questionnaires to a random sample of 300 firms who had completed peer review as of January



Source: American Institute of Certified Public Accountants, Audit Quality: The Profession's Program (New York: American Institute of Certified Public Accountants, 1984): 17

Figure 14. Processing of Peer Review Reports

1982. The 156 firms who responded had a total of 141 major deficiencies in their quality control programs. The distribution shown in Figure 15 below clearly shows supervision and inspection to be the most troublesome areas.

<u>Quality Control Elements</u>	<u>Number</u>	<u>Percent</u>
1. Independence	2	1.4
2. Assigning Personnel	1	0.7
3. Consultation	5	5.7
4. Supervision	85	60.3
5. Hiring	0	0.0
6. Professional Development	6	4.3
7. Advancement	9	6.4
8. Acceptance and Continuance of Clients	7	5.0
9. Inspection	<u>23</u>	<u>16.3</u>
TOTAL	141	100.1

Source: Joseph A. DeFatta, "Quality Control Deficiencies Cited by Peer Review Teams," Virginia Accountant ----- (----- 1986): 28.

Figure 15. Deficiencies in Quality Control

While supervision was the most frequently cited deficiency, further analysis by DeFatta and Smith noted that it was not considered the most serious. Of the ten respondents who stated why they did not receive an unqualified report, two were for lack of written audit

programs and three were due to multiple infractions of the nine elements of quality control, but five were due solely to inadequate internal inspection programs. [Ref. 29:p. 30]

One additional study is of particular interest. Kenneth R. Austin teamed with David C. Langston in 1981 to survey the financial community on its opinion of peer review. They chose a sample that consisted of 133 CPAs and 63 non-CPAs, who were drawn from the national directory of the Financial Executives Institute. They sought to test three hypotheses:

1. CPAs believe that peer review will enhance the profession's standards of quality control.
2. Peer review is seen by both CPAs and non-CPAs as a step by the profession to assure self-regulation.
3. Peer review is cost justified as a means of decreasing litigation brought against CPAs and as a means of providing added credibility to the public accounting profession. [Ref. 35:p. 79]

In general, 75% of the CPAs who responded to the survey agreed that peer review will improve audit quality. The 25% who did not agree feel their quality systems could not be improved by peer review. When asked about the effect of peer review on each individual element of quality control, respondents felt that inspection could benefit the most from peer review, but that consultation would benefit the least. [Ref. 35:pp. 79-81]

Only 65% of the CPAs felt peer review was an adequate means of self-regulation. Those CPAs who did not agree were most concerned that the profession would become

dominated by the views and philosophies of the large CPA firms. Non-CPAs, conversely, were highly supportive of the profession's efforts to avoid government regulation. Bankers, in particular, felt that "governmental control would create an abundance of bureaucratic waste and interference that would impose exorbitant compliance costs and hardships" [Ref. 35:p. 82]. Furthermore, they felt that government regulation might lead to a "super agency" that would not be able to respond expeditiously in the dynamic arena of financial management.

Finally, the majority of CPAs (67%) disagreed with statement three, that peer review is cost justified. Most felt credibility was already at an acceptable level. Others noted that while one peer review might be helpful, subsequent triennial reviews would not. The CPAs also did not feel that peer review will have an impact on the number of litigations brought against auditors. [Ref. 35:p. 82]

V. RECOMMENDATIONS FOR THE NAVAL AUDIT SERVICE

A. BACKGROUND

As outlined in Chapter I, the Naval Audit Service provides internal auditing for the Department of the Navy. This includes conducting efficiency and effectiveness audits and program performance reviews, in addition to the more traditional compliance and financial audits. The military's internal audit function comes under the purview of the Department of Defense Inspector General, and the Navy, Army and Air Force each have an internal audit agency. Recent audit work by the Naval Audit Service included a review of aviation supply management aboard aircraft carriers, reviews of the accuracy, validity and propriety of costs incurred in several recent ship overhauls, and a study of the Naval Air Systems Command's acquisition methodology for F-14A contracts.

Since it is a government agency, the Naval Audit Service must conduct its audits in accordance with Standards for Audit of Governmental Organizations, Programs, Activities, and Functions issued the Comptroller General of the United States, which are equivalent to the public accounting profession's Generally Accepted Auditing Standards. Indeed, the government standards incorporate many of the American Institute of Certified Public Accountants' Statements on

Auditing Standards. The Naval Audit Service also follows those policies and procedures outlined by the Department of Defense (DoD), which include the newly-revised Internal Audit Manual discussed earlier. It should be noted, however, that this manual was issued with six chapters labelled "to be developed"; Achieving and Maintaining Professional Proficiency, Performing Audits, Auditing Computer Based Systems, Advanced Audit Techniques, Managing Internal Audit Operations, and Reporting Audit Time.

The Secretary of the Navy has promulgated the Department of the Navy Audit Manual for Management (SECNAV Instruction 7510.7 series), which the Naval Audit Service augments with the Naval Audit Handbook. This latter document is currently undergoing revision and will include, among other changes, a new chapter on Quality Assurance. It is assumed that these documents, and indeed, internal audit operations, will remain in a state of unrest until all chapters of the DoD Internal Audit Manual are completed.

Naval Audit Service Headquarters, located in Falls Church, Virginia, is responsible for audit planning, policies, procedures, review and resources throughout the audit service. Individual audits are assigned to one or more of the four regional audit service offices, located in San Diego, California; Camden, New Jersey; Norfolk, Virginia; and Washington, D.C. These regional offices are the focal point for the actual audit work. They assign each

-audit to an audit team, composed of auditors from the GS-5 level and up. This audit team, supervised by a GS-13 Auditor-in-Charge (AIC), is responsible for staffing and executing the audit, and preparing the audit findings and report.

The program for training auditors throughout the Naval Audit Service has, in the past, been loosely structured and is currently being redesigned. It previously provided formal training courses from external sources for junior auditors when time and funding permitted. There was also at one time a series of correspondence courses available. Junior auditor development, however, was primarily accomplished by on-the-job training. Senior auditors were occasionally able to attend advanced seminars and professional meetings when funding was available. Mid-grade auditors, where a need for training in supervision and audit management existed, were provided with fewer opportunities to obtain needed training.

The Naval Audit Service's programs for audit quality are also undergoing revision. To date, they have focused primarily on the presentation and supportability of the final audit report. In addition to regional level reviews, the final reports are reviewed prior to publication by quality control personnel at Headquarters. Selected audit reports, together with their supporting workpapers, are also

reviewed after publication by headquarters quality assurance personnel.

As is obvious from the above discussion, the policies and regulations regarding the Naval Audit Service are currently undergoing a major reevaluation and revision. Given this, attempting to accurately characterize the current policies and practices with respect to audit quality is not feasible. Consequently, no attempt is made here to fully describe the current state of quality control and quality assurance within the Naval Audit Service. Instead, specific recommendations for improvements in the Naval Audit Service quality control program which should be considered in the current evolution are presented in the remainder of this chapter. These recommendations are based on observations concerning audit quality in the private sector as previously discussed.

B. GENERAL COMMENTS

The private sector's program for audit quality places most of its emphasis on building quality into the audit process. It has identified nine key areas where improved management policies and programs can ultimately enhance the quality of audit work. Each firm addresses these areas in its quality control system, which it reviews regularly for effectiveness. Additionally, the control systems are reviewed by an outside source every three years to ensure

that it is adequate and appropriate for the firm, and that it is complied with.

The Naval Audit Service, however, appears to be emphasizing compliance with government auditing standards as the principal measure of quality. This does not address the impact that audit firm management policies have on audit quality. The availability and subsequent pursuit of auditor professional development, for example, may not be required by government auditing standards but will indeed impact the quality of the final audit product, as well as the timeliness and cost of its production. The following comments, based on the private sector quality control program, identify specific areas for Naval Audit Service consideration.

C. SPECIFIC COMMENTS

1. Staffing

Perhaps the most fundamental element in an audit quality program is ensuring that appropriately trained and experienced people are performing the audit work. Before hiring and training objectives can be set, however, the organization must first determine its staffing needs.

Since a public accounting firm deals principally with financial statements, it is staffed primarily with accountants. The Institute of Internal Auditors, however, recommends the following considerations for staffing an internal audit department:

220 Knowledge, Skills, and Disciplines

The internal auditing department should possess or should obtain the knowledge, skills, and disciplines needed to carry out its audit responsibilities.

- .01 The internal auditing staff should collectively possess the knowledge and skills essential to the practice of the profession within the organization. These attributes include proficiency in applying internal auditing standards, procedures, and techniques.
- .02 The internal auditing department should have employees or use consultants who are qualified in such disciplines as accounting, economics, finance, statistics, electronic data processing, engineering, taxation, and law as needed to meet audit responsibilities. Each member of the department, however, need not be qualified in all of these disciplines. [Ref. 22:pp. 200-1]

Indeed, one recent article lauding the General Accounting Office's shift from financial auditing to oversight of government programs noted:

When Elmer Staats became Comptroller General in 1966, accountants made up 96% of his professional staff. When he retired, half his staff consisted of lawyers, economists, engineers and computer specialists. [Ref. 1:p.32]

Presently, nearly all of the auditor positions in the Naval Audit Service, and most of the staff positions as well, are classified in the GS-511 Auditor series. While this series does include the performance of evaluations and analyses beyond the purely fiscal, it is, nonetheless, heavily tied to financial accounting. Indeed, the qualification standards for the GS-510 Accountant series are virtually the same as those for GS-511 Auditors.

As the Naval Audit Service broadens its audit services to areas outside of financial and compliance auditing, however, it should consider broadening its

technical base with professionals in such complementary fields as management analysis, budget analysis, systems analysis, information systems, financial management and operations research.

2. Assignment of Personnel

Once the appropriate staff is on board, assignment procedures should be established that ensure its effective utilization. The objective of the system should be to match audit requirements with auditor abilities, considering such other variables as timing, training needs and availability of supervision.

This method of building audit teams on an audit-by-audit basis would obviously complicate scheduling dramatically, but it would also allow training and administrative time to be scheduled between audit team assignments. Junior auditors would have the opportunity to work and train under several seniors, and all auditors would receive a variety of inputs for their evaluation, advancement and career development.

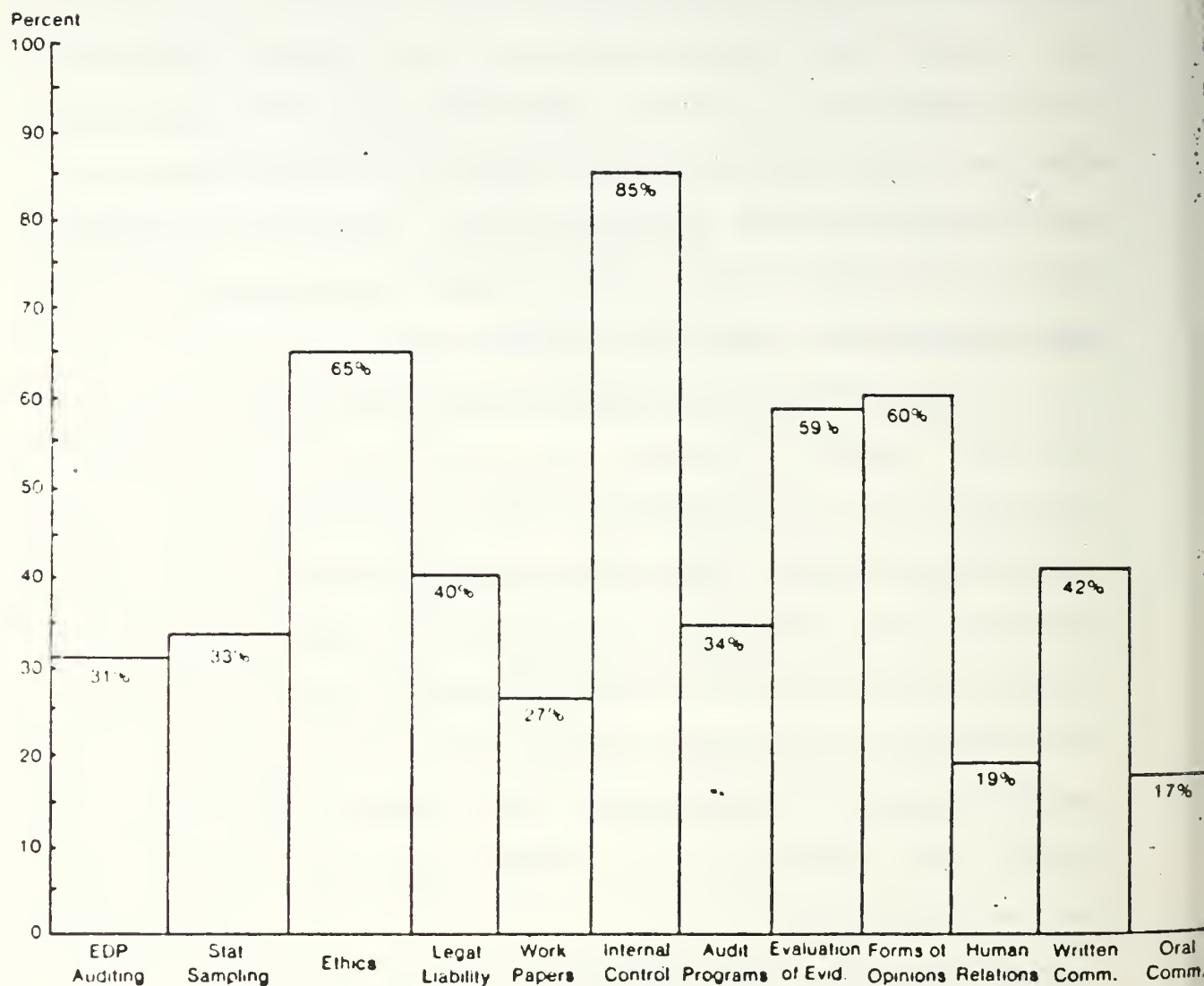
Two other issues concerning assignment of personnel should be mentioned here. The first is the use of senior, experienced auditors for consultation. While the Naval Audit Service does provide such a program, most of their specialists are located at Naval Audit Service Headquarters in Falls Church, Virginia, where they are not readily accessible to audit teams in the field.

Secondly, nearly every auditor interviewed at the regional and audit team levels noted that Auditors-in-Charge (AICs) do not have a sufficient amount of time to supervise their audit teams. For example, it was reported that it is not uncommon for an audit team to conduct the pre-audit survey on a new audit while the team's AIC is completing the smooth report for the previous audit. Yet AIC involvement in the pre-audit survey is critical in determining the appropriateness of subsequent audit work.

Both of these assignment issues could be alleviated, and audit quality improved, by moving some of the upper level auditors at headquarters out to the regions. The regions would benefit from on-site consultation and training services. The specialists would be in closer contact with the audit environment, and could function as backup AICs. This would be especially useful for quality control and quality assurance personnel, who could observe their programs in operation and receive immediate feedback on their effectiveness.

3. Professional Development

Chapter IV's discussion of auditor professional development is equally applicable to the Naval Audit Service. As noted there, formal education of auditors does not usually emphasize practical application of auditing techniques, as evidenced by survey results summarized in Figure 15. Of particular note to the Naval Audit Service



Source: J.W. Martin and S.R. Whisnant, "Why Johnny Can't Audit," CPA Journal 52 (November 1982): 14

Figure 15. Percentages of Professors Viewing Specific Audit Topics as Critical to an Audit Course

are the survey results for work papers, oral communication and human relations, since data gathering, oral communication and effective working relationships comprise three of the five elements currently considered critical in the evaluation of a GS-9 level auditor.

J. Efrim Boritz noted that unfortunately, many internal auditing organizations let their training programs fall into neglect, for reasons such as the following:

- Good managers are not necessarily good teachers.
- The consequences of poor training do not show up immediately but later (on the job) and may not be attributed to poor training.
- Training needs of professionals are often poorly understood.
- Actionable concepts are not taught.
- Ineffective or incorrect training methods are used.
[Ref. 36:p. 174]

Professional development should not be limited to junior auditors, however. Boritz also noted:

As an organization grows and changes, people who were once competent may become obsolete, if not outright incompetent. They may be promoted into positions of greater responsibility not only for their own work but also the work of others. [Ref. 36:p. 174]

Also emphasized in Chapter IV was the importance of top level management support of training efforts. This includes not only providing training funds, but ensuring the funds are used equitably, employing qualified personnel to develop and maintain the training program, and including training achievements in evaluations and advancements.

Further specific considerations for the Naval Audit Service include:

- Develop a training matrix encompassing all levels of staff
- Schedule certain training as a required evolution
- Develop an underlying structure for on-the-job training
- Develop in-house training programs
- Ensure all auditors who teach are trained in instruction, including those providing on-the-job training
- Ensure regional training coordinators are appropriately qualified in education, training and career development
- Establish a requirement for continuing professional education
- Encourage and recognize the attainment of certification
- Provide a feedback mechanism on the quality and effectiveness of all training, including on-the-job training

4. Certification

The backbone of the AICPA's Quality Control program is professional certification, whether it is an individual CPA or as a member of a firm belonging to the Division for CPA firms. Both designations carry with them minimum ethical, educational and performance standards that must be met and maintained for continued certification.

The issue of certification for government accountants and auditors is a controversial one. The Association of Government Accountants (AGA) recently initiated a study into the need and feasibility of a program leading to designation as a Certified Government Accountant (CGA). The objectives of their program were summed up as follows:

A certified government accountant program is needed to demonstrate a level of competency in this segment of the accounting and auditing profession. A program of certification would promote education opportunities in the area of government accounting, encourage a continuing education program in the area of expertise, and assist governmental financial managers in hiring the most qualified professional staff. Further, a certification program would facilitate the general public's recognition of the specialized qualifications of government accountants and auditors and provide government organizations engaging independent audit services with additional technical criteria for use in making meaningful comparisons of the relative merits of audit proposals. [Ref. 37:p. 46]

Until such a program is developed, however, there are several existing certification programs that relate to the functions of the Naval Audit Service. They include the Certified Public Accountant (CPA), Certified Internal Auditor (CIA) and Certified Management Accountant (CMA), each of whose subject expertise is listed in Figure 16 below. Several more specialized designations are also available.

Certification signifies not only the attainment of and dedication to professional standards, but also a commitment to continuing education and professional development. Encouragement and subsequent recognition of individual certification should be strongly encouraged by the Naval Audit Service, and possibly made mandatory for advancement to key supervisory positions.

5. Evaluation and Advancement

Lennis M. Knighton states that advancement is a quality control element only if auditors are treated like other professionals, who must "stand or fall" based on their

CPA	CMA	CIA
Auditing	Auditing	Auditing
Quantitative Methods	Quantitative Methods	Quantitative Methods
Financial Accounting	Financial Accounting	Financial Accounting
Federal Taxation	Federal Taxation	
Cost Accounting	Managerial and Cost Accounting	
Business Law	Economics	Economics
Governmental & Nonprofit Accounting	Information Systems & Data Processing	Information Systems & Data Processing
	Management	Management
	Business Finance	Managerial Finance

Source: Lynn Rans, "Certification--Mark of a Professional," Armed Forces Comptroller 30 (Fall 1985): 13

Figure 16. Subject Expertise for Certification

performance. He adds: "Make excellence in performance the key to advancement, not their time in grade, seniority, veterans' preference, status or other criteria" [Ref. 24:p. 9].

Individual commitment to audit quality objectives requires subsequent recognition in the evaluation and advancement programs. To this end, the Naval Audit Service should develop a more meaningful evaluation process, which would also be useful in making audit team assignments and developing individual training programs. Consideration should also be given to evaluating at least the more junior auditors at the close of each engagement, vice only on an annual basis.

6. Review

The Naval Audit Service currently has review mechanisms in place at virtually every stage of the audit process. These reviews appear to focus almost exclusively, however, on procedural compliance with auditing standards, and the presentation and supportability of the final audit report. These reviews, then, are roughly equivalent to the engagement review portion of the private sector's peer review program.

While engagement reviews are admittedly critical to ensuring quality of the final audit product, two other reviews are also necessary to ensure an effective audit quality program overall. The first is similar to a review of internal controls in an audit, or roughly equivalent to the quality control system review portion of peer review. It involves reviewing for compliance with existing quality control procedures, which requires the implementation of a

well-defined, standardized, measurable quality control system.

The second type of review needed by the Naval Audit Service is a review of the design and appropriateness of the quality control program, which falls under the purview of quality assurance as it is defined by the manufacturing industry:

The system involves a continuing evaluation of the adequacy and effectiveness of the overall quality control program with a view to having corrective measures initiated where necessary. For a specific product or service, this involves specifications, audits, and the evaluation of the quality factors that affect the specification, production, inspection, and use of the product or service. [Ref. 6:p. 181]

This would include such functions as conducting trend analyses and monitoring changes in external standards so as to identify areas in the program that need to be adjusted or amended.

D. AREAS FOR FURTHER RESEARCH

1. Systems of Quality Control in the Private Sector's Internal Audit Function

Private industry employs its own internal auditors to accomplish many of the same types of tasking as the Naval Audit Service, such as ensuring efficient and effective use of resources. While each segment of industry, and indeed, each individual company, may charter its internal audit department differently, a study of their organization, staffing, training, procedures, and quality control elements

might also identify enhancements useful to the Naval Audit Service's quality program.

2. Staffing Needs for the DoD Internal Audit Function

As discussed above, staffing of the DoD internal audit function is primarily composed of GS-511 auditors. A study of staffing needs, based on mission objectives, may identify other series that would benefit the internal audit mission, as well as possibly outline a separate series or separate benchmarks for internal auditors vice financial auditors.

3. Survey of Audit Clients for Measures of Audit Quality

A survey of recent and/or potential audit clients as to their requirements for a quality audit could reveal areas which could benefit from new staffing considerations or other quality enhancements.

APPENDIX A

STATEMENT ON QUALITY CONTROL SYSTEMS NO. 1

SYSTEM OF QUALITY CONTROL FOR A CPA FIRM

(This statement provides that a CPA firm shall have a system of quality control and describes elements of quality control and other matters essential to the effective implementation of the system)

1. Quality control for a CPA firm, as referred to in this statement, applies to all auditing and accounting and review services for which professional standards have been established.¹ Although the provisions of this statement may be applied to other segments of a firm's practice, such as providing tax services or management advisory services, their applicability to those segments of practice is not prescribed by this statement, except to the extent that such services are a part of the abovementioned auditing and accounting and review services.

2. In providing professional services, a firm has a responsibility to conform with professional standards. In accepting this responsibility, there is a presumption that the firm will consider the integrity of individuals in determining its professional relationships, that the firm and its people will be independent of its clients to the extent required by the AICPA's rules of conduct, and that the firm's personnel will be professionally competent, will

¹Firm is defined in the AICPA rules of conduct as "A proprietorship, partnership, or professional corporation or association engaged in the practice of public accounting, including individual partners or shareholders thereof." Professional standards, as referred to in this statement, are those that relate to the professional qualities and performance of individual members of the AICPA and, accordingly, include the rules of conduct of the AICPA, pronouncements of the AICPA Auditing Standards Board and its predecessor committees, and pronouncements of the AICPA Accounting and Review Services Committee.

be objective, and will exercise due professional care² To provide itself with reasonable assurance of meeting its responsibility to provide professional services that conform with professional standards, a firm shall have a system of quality control.

SYSTEM OF QUALITY CONTROL

3. A system of quality control for a firm encompasses the firm's organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of conforming with professional standards. The system of quality control should be appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

4. Any system of quality control has inherent limitations that can reduce its effectiveness. Variance in individual performance and understanding of professional requirements affects the degree of compliance with a firm's prescribed quality control policies and procedures and, therefore, the effectiveness of the system.

5. The system of quality control for a U.S. firm should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards in the United States.³

ESTABLISHMENT OF QUALITY CONTROL POLICIES AND PROCEDURES

6. The nature and extent of a firm's quality control policies and procedures depend on a number of factors, such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its

²Unless the text states otherwise, the term personnel encompasses all of a firm's professionals performing services to which this statement applies and includes proprietors, partners, principals, and stockholders or officers of professional corporations, and their professional employees.

³SAS No. 1, section 543, provides guidance regarding procedures to be considered on individual audit engagements when the principal auditor utilizes the work of other auditors.

practice, its organization, and appropriate cost-benefit considerations.⁴

7. A firm shall consider each of the elements of quality control discussed below, to the extent applicable to its practice, in establishing its quality control policies and procedures. The elements of quality control are inter-related. Thus, a firm's hiring practices affect its policies as to training. Training practices affect policies as to promotion. Practices in both categories affect policies as to supervision. Practices as to supervision, in turn, affect policies as to training and promotion.

a. Independence. Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct contains examples of instances wherein a firm's independence will be considered to be impaired.

b. Assigning Personnel to Engagements. Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

c. Consultation. Policies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation will depend on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

d. Supervision. Policies and procedures for the conduct and supervision of work at all organizational levels

⁴The Guide to Implement the Voluntary Quality Control Review Program for CPA Firms--Quality Control Policies and Procedures for Participating CPA Firms, which has been issued by the AICPA under the voluntary quality control review program for CPA firms, may be useful to a firm in considering its quality control policies and procedures.

should be established to provide the firm with reasonable assurance that the work performed meets the firm's standards of quality. The extent of supervision and review appropriate in a given instance depends on many factors, including the complexity of the subject matter, the qualifications of the persons performing the work, and the extent of consultation available and used. The responsibility of a firm for establishing procedures for supervision is distinct from the responsibility of individuals to adequately plan and supervise the work on a particular engagement.

e. Hiring. Policies and procedures for hiring should be established to provide the firm with reasonable assurance that those employed possess the appropriate characteristics to enable them to perform competently. The quality of a firm's work ultimately depends on the integrity, competence, and motivation of personnel who perform and supervise the work. Thus, a firm's recruiting programs are factors in maintaining such quality.

f. Professional Development. Policies and procedures for professional development should be established to provide the firm with reasonable assurance that personnel will have the knowledge required to enable them to fulfill responsibilities assigned. Continuing professional education and training activities enable a firm to provide personnel with the knowledge required to fulfill responsibilities assigned to them and to progress within the firm.

g. Advancement. Policies and procedures for advancing personnel should be established to provide the firm with reasonable assurance that those selected for advancement will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume. Practices in advancing personnel have important implications for the quality of a firm's work. Qualifications that personnel selected for advancement should possess include, but are not limited to, character, intelligence, judgment, and motivation.

h. Acceptance and Continuance of Clients. Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity. Suggesting that there should be procedures for this purpose does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its professional relationships.

i. Inspection. Policies and procedures for inspection should be established to provide the firm with reasonable assurance that the procedures relating to the other elements of quality control are being effectively applied. Procedures for inspection may be developed and performed by individuals acting on behalf of the firm's management. The type of inspection procedures used will depend on the controls established by the firm and the assignment of responsibilities within the firm to implement its quality control policies and procedures.

ASSIGNMENT OF RESPONSIBILITIES

8. A firm shall assign responsibilities to its personnel to the extent required to effectively implement its quality control policies and procedures, in the assignment of responsibilities, appropriate consideration should be given to the competence of the individuals, the authority delegated to them, and the extent of supervision provided.

COMMUNICATION

9. A firm shall communicate to its personnel its quality control policies and procedures in a manner that will provide reasonable assurance that such policies and procedures are understood. The form and extent of such communication should be sufficiently comprehensive to provide the firm's personnel with information concerning the quality control policies and procedures applicable to them. Although communication ordinarily is enhanced if the communication is in writing, the effectiveness of a firm's system of quality control is not necessarily impaired by the absence of documentation of established quality control policies and procedures. The size, structure, and nature of practice of the firm should be considered in determining whether documentation of quality control policies and procedures is required and, if so, the extent of such documentation. Normally, documentation of quality control policies and procedures would be expected to be more extensive in a larger firm than in a smaller firm and more extensive in a multi-office firm than in a single-office firm.

MONITORING

10. A firm shall monitor the effectiveness of its system of quality control by evaluating on a timely basis its quality control policies and procedures, assignment of responsibilities, and communication of policies and procedures. The

size, structure, and nature of practice of a firm influence both the requirements and the limitations of its monitoring function. Implicit in the monitoring function is timely modification of policies and procedures, assignment of responsibilities, and the form and extent of communication, as required by new authoritative pronouncements or by other changes in circumstances, including those resulting from expansion of practice or opening of offices, merging of firms, or acquiring of practices. Monitoring activities include, but are not limited to, the quality control element of inspection.

APPENDIX B

INTERNATIONAL AUDITING GUIDELINE 7

CONTROL OF THE QUALITY OF AUDIT WORK

Introduction

1. International Auditing Guideline 3, Basic Principles Governing an Audit, states (paragraphs 9 and 10):

"When the auditor delegates work to assistants or use work performed by other auditors or experts, he continues to be responsible for forming and expressing his opinion on the financial information.

The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose."

2. The purpose of this Guideline is to provide guidance as to:

- the procedures to be followed by the auditor to comply with this basic principle as it relates to the work delegated to assistants on an individual audit, and
- the policies and procedures to be adopted by an audit firm to provide reasonable assurance regarding the quality of audit work generally.

The control procedures to be followed in respect of an individual audit should be designed in the context of the general quality controls adopted by an audit firm. The latter augment and facilitate the former, but does not replace them.

3. In this Guideline, financial information encompasses financial statements and the following terms have the meaning attributed below.

audit firm:	audit firm or a sole practitioner employing assistants;
personnel:	all partners and professional staff of an audit firm;
the auditor:	the auditor with final responsibility for the audit;

assistants: personnel involved in an individual audit other than the auditor.

Control on Individual Audits

Delegation

4. Any delegation of work to assistants should be in a manner that provides reasonable assurance that such work will be performed by persons having independence and the degree of skills and competence required in the circumstances.
5. The auditor and assistants with supervisory responsibilities should consider the skills and competence of assistants in performing the work that is delegated to them in deciding on the extent of direction, supervision and review appropriate to each.
6. Appropriate directions should be given to assistants to whom work is delegated. Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems, that may affect the nature, timing and extent of audit procedures with which they are involved.
7. A written audit program is an important tool for the communication of audit directions. Time budgets and planning memoranda are also helpful in communicating audit directions.

Supervision

8. Supervision is closely related to both direction and review, and may involve elements of both.
9. Personnel carrying out supervisory responsibilities should perform the following functions during the performance of an audit:
 - a) Monitor the progress of the work to determine that:
 - assistants appear to have the necessary skills and competence to carry out their assigned tasks;
 - assistants appear to understand the audit directions; and
 - the work is being carried out in accordance with the audit program and other planning documents.

- b) Become informed of significant accounting and auditing questions raised during the audit, assess their significance, and modify the audit program where appropriate.
- c) Resolve any differences of professional judgment between personnel.

Review

- 10. The work performed by each assistant should be reviewed by personnel of equal or higher competence to determine whether:
 - a) The work has been performed in accordance with professional and firm standards.
 - b) The work performed and the results obtained have been adequately documented.
 - c) Any significant audit matters remain unresolved.
 - d) The objectives of the audit procedures have been achieved and the conclusions expressed are consistent with the results of the work performed and support the auditor's opinion on the financial information.
- 11. The following major review stages can often be identified in an audit:
 - a) Review of the initial audit plan and the audit program.
 - b) Review of the study and evaluation of internal control, including compliance procedures, and of the modifications, if any, made to the audit program as a result thereof.
 - c) Review of the documentation of the audit evidence obtained and the conclusions drawn therefrom.
 - d) Review of the financial information and proposed auditor's report.
- 12. Review procedures may be augmented, particularly in the case of large complex audits, by requesting personnel not otherwise involved in the audit to perform certain additional review procedures before issuance of the auditor's report.

General Quality Controls

13. Quality controls are the policies and procedures adopted by a firm to provide reasonable assurance that all audits done by the firm are being carried out in accordance with the Basic Principles Governing An Audit, as set out in International Auditing Guideline 3.
14. Quality control policies are objectives and goals; quality control procedures are steps to be taken to accomplish the policies adopted.
15. An audit firm should adopt quality control policies that incorporate the following objectives and should implement appropriate procedures that provide reasonable assurance of achieving those objectives:

A. Personal Qualities

Personnel in the firm should adhere to the principles of Integrity, Objectivity, Independence and Confidentiality, as stated in the IFAC guideline "Professional Ethics for the Accountancy Profession."

B. Skills and Competence

The firm should be staffed by personnel who have attained and maintain the skills and competence required to enable them to fulfill their responsibilities.

C. Assignment

Audit work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

D. Direction and Supervision

There should be sufficient direction and supervision of work at all levels to provide the firm with reasonable assurance that the work performed by the firm meets appropriate standards of quality. Whenever necessary, consultation should be made with those who have appropriate expertise.

E. Acceptance and Continuance of Clients

The firm should carry out an evaluation of a prospective client prior to acceptance and should review, on an ongoing basis, the association with existing clients. In making a decision to accept or continue with a client, a firm should consider its own independence, its

ability to service a client properly, and the integrity of the client's management.

F. Inspection

The firm should monitor the effectiveness of its quality control policies and procedures.

16. A firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood.
17. The nature and extent of a firm's quality control procedures depend on a number of factors such as the size and nature of its practice, its geographic dispersion, its organization and appropriate cost/benefit considerations. Accordingly, the procedures adopted by individual firms will vary, as will the extent of their documentation. Illustrative examples of quality control procedures are presented in an appendix to this guideline. The specific procedures used by a firm would not necessarily include all the illustrative examples or be limited to them, nor would all procedures carry the same weight for all circumstances. In addition, many of the illustrative examples may not be appropriate to smaller firms.

APPENDIX
ILLUSTRATIVE EXAMPLES OF
GENERAL QUALITY CONTROL PROCEDURES

As explained in the preceding Guideline, an audit firm should establish quality control policies and procedures that provide the firm with reasonable assurance that all audits done by it are being carried out in accordance with the Basic Principles Governing an Audit, as set out in International Auditing Guideline 3.

Policy--Personal Qualities

- A. Personnel in the firm should adhere to the principles of Integrity, Objectivity, Independence and Confidentiality, as stated in the IFAC guideline "Professional Ethics for the Accountancy Profession."

Procedures

1. Assign an individual or group to provide guidance and to resolve questions on matters of integrity, objectivity, independence and confidentiality.
 - a. Identify circumstances where documentation as to the resolution of questions would be appropriate.
 - b. Require consultation with authoritative sources when considered necessary.
2. Communicate policies and procedures relating to independence to personnel at all levels within the firm.
 - a. Inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures.
 - b. Emphasize independence of mental attitude in training programs and in supervision and review of audits.
 - c. Apprise personnel on a timely basis of those entities to which independence policies apply.
 - (i) Prepare and maintain for independence purposes a list of the firm's clients and of other entities (client's affiliates, parents, associates, and so forth) to which independence policies apply.

- (ii) Make the list available to personnel (including personnel new to the firm or to an office) who need it to determine their independence.
 - (iii) Establish procedures to notify personnel of changes in the list.
- 3. Monitor compliance with policies and procedures relating to independence.
 - a. Obtain from personnel periodic written representations, normally on an annual basis, stating that--
 - (i) They are familiar with the firm's independence policies and procedures.
 - (ii) Prohibited investments are not held and were not held during the period.
 - (iii) Prohibited relationships do not exist, and transactions prohibited by firm policy have not occurred.
 - b. Assign responsibility for resolving exceptions to a person or group with appropriate authority.
 - c. Assign responsibility for obtaining representations and reviewing independence compliance files for completeness to a person or group with appropriate authority.
 - d. Review periodically the firm's association with clients to ascertain whether any areas of involvement may impair the firm's independence.

Policy--Skills and Competence

- B. The firm should be staffed by personnel who have attained and maintain the competence required to enable them to fulfill their responsibilities.

Procedures

- 1. Maintain a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.
 - a. Plan for the firm's personnel needs at all levels and establish quantified hiring objectives based on current clientele, anticipated growth, and retirement.

- b. Design a program to achieve hiring objectives which provides for--
 - (i) Identification of sources of potential hirees.
 - (ii) Methods of contact with potential hirees.
 - (iii) Methods of specific identification of potential hirees.
 - (iv) Methods of attracting potential hirees and informing them about the firm.
 - (v) Methods of evaluating and selecting potential hirees for extension of employment offers.
 - c. Inform those persons involved in hiring as to the firm's personnel needs and hiring objectives.
 - d. Assign to authorized persons the responsibility for employment decisions.
 - e. Monitor the effectiveness of the recruiting program.
 - (i) Evaluate the recruiting program periodically to determine whether policies and procedures for obtaining qualified personnel are being observed.
 - (ii) Review hiring results periodically to determine whether goals and personnel needs are being achieved.
2. Establish qualifications and guidelines for evaluating potential hirees at each professional level.
- a. Identify the attributes to be sought in hirees, such as intelligence, integrity, honesty, motivation and aptitude for the profession.
 - b. Identify achievements and experiences desirable for entry level and experienced personnel. For example:
 - (i) Academic background.
 - (ii) Personal achievements.
 - (iii) Work experience.
 - (iv) Personal interests.

- c. Set guidelines to be followed when hiring individuals in situations such as--
 - (i) Hiring relatives of personnel or relative of clients.
 - (ii) Rehiring former employees.
 - (iii) Hiring client employees.
 - d. Obtain background information and documentation of qualifications of applicants by appropriate means, such as--
 - (i) Resumes.
 - (ii) Application forms.
 - (iii) Interviews.
 - (iv) Academic record.
 - (v) Personal references.
 - (vi) Former employment references.
 - e. Evaluate the qualifications of new personnel, including those obtained from other than the usual hiring channels (for example, those joining the firm at supervisory levels or through merger or acquisition), to determine that they meet the firm's requirements and standards.
- 3. Inform applicants and new personnel of the firm's policies and procedures relevant to them.
 - a. Use a brochure or other means to inform applicants and new personnel.
 - b. Prepare and maintain a manual describing policies and procedures for distribution to personnel.
 - c. Conduct an orientation program for new personnel.
 - 4. Establish guidelines and requirements for continuing professional education and communicate them to personnel.
 - a. Assign responsibility for the professional development function to a person or group with appropriate authority.

- b. Provide that programs developed by the firm be reviewed by qualified individuals. Programs should contain statements of objectives and education and/or experience prerequisites.
- c. Provide an orientation program relating to the firm and the profession for newly employed personnel.
 - (i) Prepare publications and programs designed to inform newly employed personnel of their professional responsibilities and opportunities.
 - (ii) Assign responsibility for conducting orientation conferences to explain professional responsibilities and firm policies.
- d. Establish continuing professional education requirements for personnel at each level within the firm.
 - (i) Consider legislative and professional bodies' requirements or voluntary guidelines in establishing firm requirements.
 - (ii) Encourage participation in external continuing professional education programs, including self-study courses.
 - (iii) Encourage membership in professional organizations. Consider having the firm pay or contribute toward membership dues and expenses.
 - (iv) Encourage personnel to serve on professional committees, prepare articles, and participate in other professional activities.
- e. Monitor continuing professional education programs and maintain appropriate records, both on a firm and an individual basis.
 - (i) Review periodically the records of participation by personnel to determine compliance with firm requirements.
 - (ii) Review periodically evaluation reports and other records prepared for continuing education programs to evaluate whether the programs are being presented effectively and are accomplishing firm objectives. Consider the need for new programs and for revision or elimination of ineffective programs.

5. Make available to personnel information about current developments in professional technical standards and materials containing the firm's technical policies and procedures and encourage personnel to engage in self-development activities.
 - a. Provide personnel with professional literature relating to current developments in professional technical standards.
 - (i) Distribute to personnel material of general interest, such as relevant international and national pronouncements on accounting and auditing matters.
 - (ii) Distribute pronouncements on relevant regulations and statutory requirements in areas of specific interest, such as company securities and taxation law, to persons who have responsibility in such areas.
 - (iii) Distribute manuals containing firm policies and procedures on technical matters to personnel. Manuals should be updated for new developments and changing conditions.
 - b. For training programs presented by the firm, develop or obtain course materials and select and train instructors.
 - (i) State the program objectives and education and/or experience prerequisites in the training programs.
 - (ii) Provide that program instructors be qualified as to both program content and teaching methods.
 - (iii) Have participants evaluate program content and instructors of training sessions.
 - (iv) Have instructors evaluate program content and participants in training sessions.
 - (v) Update programs as needed in light of new developments, changing conditions, and evaluation reports.
 - (vi) Maintain a library or other facility containing professional, regulatory and firm

literature relating to professional technical matters.

6. Provide, to the extent necessary, programs to fill the firm's needs for personnel with expertise in specialized areas and industries.
 - a. Conduct firm programs to develop and maintain expertise in specialized areas and industries, such as regulated industries, computer auditing, and statistical sampling methods.
 - b. Encourage attendance at external education programs, meetings, and conferences to acquire technical or industry expertise.
 - c. Encourage membership and participation in organizations concerned with specialized areas and industries.
 - d. Provide technical literature relating to specialized areas and industries.
7. Establish qualifications deemed necessary for the various levels of responsibility within the firm.
 - a. Prepare guidelines describing responsibilities at each level and expected performance and qualifications necessary for advancement to each level, including--
 - (i) Titles and related responsibilities.
 - (ii) The amount of experience (which may be expressed as a time period) generally required for advancement to the succeeding level.
 - b. Identify criteria which will be considered in evaluating individual performance and expected proficiency, such as--
 - (i) Technical knowledge.
 - (ii) Analytical and judgmental abilities.
 - (iii) Communicative skills.
 - (iv) Leadership and training skills.
 - (v) Client relations.

- (vi) Personal attitude and professional bearing (character, intelligence, judgment and motivation).
 - (vii) Qualification as a professional accountant for advancement to a supervisory position.
 - c. Use a personnel manual or other means to communicate advancement policies and procedures to personnel.
8. Evaluate performance of personnel and advise personnel of their progress.
- a. Gather and evaluate information on performance of personnel.
 - (i) Identify evaluation responsibilities and requirements at each level indicating who will prepare evaluations and when they will be prepared.
 - (ii) Instruct personnel on the objectives of personnel evaluation.
 - (iii) Utilize forms, which may be standardized, for evaluating performance of personnel.
 - (iv) Review evaluations with the individual being evaluated.
 - (v) Require that evaluations be reviewed by the evaluator's superior.
 - (vi) Review evaluations to determine that individuals worked for and were evaluated by different persons.
 - (vii) Determine that evaluations are completed on a timely basis.
 - (viii) Maintain personnel files containing documentation and career opportunities.
 - b. Periodically counsel personnel as to their progress and career opportunities.
 - (i) Review periodically with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include the following:
 - (a) Performance.

- (b) Future objectives of the firm and the individual.
 - (c) Assignment preference.
 - (d) Career opportunities.
- (ii) Evaluate partners periodically by means of senior partner or fellow partner evaluation and counseling as to whether they continue to have the qualifications to fulfill their responsibilities.
 - (iii) Review periodically the system of personnel evaluation and counseling to ascertain that--
 - (a) Procedures for evaluation and documentation are being followed on a timely basis.
 - (b) Requirements established for advancement are being achieved.
 - (c) Personnel decisions are consistent with evaluations.
 - (d) Recognition is given to outstanding performance.

9. Assign responsibility for making advancement decisions.

- a. Assign responsibility to designated persons for making advancement and termination decisions, conducting evaluation interviews with persons considered for advancement, documenting the results of the interviews, and maintaining appropriate records.
- b. Evaluate data obtained giving appropriate recognition in advancement decisions to the quality of the work performed.
- c. Study the firm's advancement experience periodically to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility.

Policy--Assignment

- C. Audit work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

Procedures

1. Delineate the firm's approach to assigning personnel, including the planning of overall firm and office needs and the measures employed to achieve a balance of audit manpower requirements, personnel skills, individual development and utilization.
 - a. Plan the personnel needs of the firm on an overall basis and for individual practice offices.
 - b. Identify on a timely basis the staffing requirements of specific audits.
 - c. Prepare time budgets for audits to determine manpower requirements and to schedule audit work.
 - d. Consider the following factors in achieving a balance of audit manpower requirements, personal skills, individual development and utilization--
 - (i) Audit size and complexity.
 - (ii) Personnel availability.
 - (iii) Special expertise required.
 - (iv) Timing of the work to be performed.
 - (v) Continuity and periodic rotation of personnel.
 - (vi) Opportunities for on-the-job training.
2. Assign an appropriate person or persons to be responsible for assigning personnel to audits.
 - a. Consider the following in making assignments of individuals--
 - (i) Staffing and timing requirements of the specific audit.
 - (ii) Evaluations of the qualifications of personnel as to experience, position, background, and special expertise.

- (iii) The planned supervision and involvement by supervisory personnel.
 - (iv) Projected time availability of individuals assigned.
 - (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to audits for clients who are former employers or are employers of certain kin.
- b. Give appropriate consideration, in assigning personnel, to both continuity and rotation to provide for efficient conduct of the audit and the perspective of other personnel with different experience and backgrounds.
- 3. Provide for approval of the scheduling and staffing of the audit by the auditor.
 - a. Submit, where necessary, for review and approval the names and qualifications of personnel to be assigned to an audit.
 - b. Consider the experience and training of the audit personnel in relation to the complexity or other requirements of the audit, and the extent of supervision to be provided.

Policy--Direction and Supervision

- D. There should be sufficient direction and supervision of work at all levels to provide the firm with reasonable assurance that the work performed by the firm meets appropriate standards of quality. Whenever necessary, consultation should be made with those who have appropriate expertise.

Procedures

- 1. Provide procedures for planning audits.
 - a. Assign responsibility for planning an audit. Involve appropriate personnel assigned to the audit in the planning process.
 - b. Develop background information or review information obtained from prior audits and update for changed circumstances.

c. Describe matters to be included in the audit planning process, such as the following--

- (i) Development of proposed work programs.
- (ii) Determination of manpower requirements and need for specialized knowledge.
- (iii) Development of estimates of time required to complete the audit.
- (iv) Consideration of current economic conditions affecting the client or its industry and their potential impact on the conduct of the audit.

2. Provide procedures for maintaining the firm's standards of quality for the work performed.

- a. Provide adequate supervision at all organizational levels, considering the training, ability and experience of the personnel assigned.
- b. Develop guidelines for the form and content of working papers.
- c. Utilize standardized forms, checklists, and questionnaires to the extent appropriate to assist in the performance of audits.
- d. Provide procedures for resolving differences of professional judgment among personnel involved in an audit.

3. Identify areas and specialized situations where consultation is required and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.

- a. Inform personnel of the firm's consultation policies and procedures.
- b. Specify areas or specialized situations requiring consultation because of the nature or complexity of the subject matter. Examples include--
 - (i) Application of newly issued technical pronouncements.
 - (ii) Industries with special accounting, auditing or reporting requirements.
 - (iii) Emerging practice problems.

- (iv) Filing requirements of legislative and regulatory bodies.
- c. Maintain or provide access to adequate reference libraries and other authoritative sources.
 - (i) Establish responsibility for maintaining a reference library in each practice office.
 - (ii) Maintain technical manuals and issue technical pronouncements, including those relating to particular industries and other specialties.
 - (iii) Maintain consultation arrangements with other firms and individuals where necessary to supplement firm resources.
 - (iv) Refer problems to a division or group in the professional body established to deal with technical inquiries.
- 4. Designate individuals as specialists to serve as authoritative sources and define their authority in consultative situations. Provide procedures for resolving differences of opinion between audit personnel and specialists.
 - a. Designate individuals as specialists for filings with legislative and other regulatory bodies.
 - b. Designate specialists for particular industries.
 - c. Advise personnel of the degree of authority to be accorded specialists' opinions and of the procedures to be followed for resolving differences of opinion with specialists.
- 5. Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required.
 - a. Advise personnel as to the extent of documentation to be prepared and the responsibility for its preparation.
 - b. Indicate where consultation documentation is to be maintained.
 - c. Maintain subject files containing the results of consultations for reference and research purposes.

6. Provide on-the-job training during the performance of audits.
 - a. Emphasize the importance of on-the-job training as a significant part of an individual's development.
 - (i) Discuss with assistants the relationship of the work they are performing to the audit as a whole.
 - (ii) Involve assistants in as many portions of the audit as practicable.
 - b. Emphasize the significance of personnel management skills and include coverage of these subjects in firm training programs.
 - c. Encourage personnel to train and develop subordinates.
 - d. Monitor assignments to determine that personnel--
 - (i) Fulfill, where applicable, the experience requirements of the relevant legislative, regulatory or professional body.
 - (ii) Gain experience in various areas of audits and varied industries.
 - (iii) Work under different supervisory personnel.

Policy--Acceptance and Continuance of Clients

- E. The firm should carry out an evaluation of a prospective client prior to acceptance and review, on an ongoing basis, the association with existing clients. In making a decision to accept or continue with a client, a firm should consider its own independence, its ability to service a client properly, and the integrity of the client's management.

Procedures

1. Establish procedures for evaluation of prospective clients and for their approval as clients.
 - a. Evaluation procedures could include the following:
 - (i) Obtain and review available financial information regarding the prospective client, such as annual reports, interim financial statements and income tax returns.

- (ii) Inquire of third parties as to any information regarding the prospective client and its management and principals which may have a bearing on evaluating the prospective client. Inquiries may be directed to the prospective client's bankers, legal advisors, investment banker, and others in the financial or business community who may have such knowledge.
 - (iii) Communicate with the predecessor auditor. Inquiries should include questions regarding the facts that might bear on the integrity of management, on disagreements with management as to accounting policies, auditing procedures, or other similarly significant matters, and on the predecessor's understanding as to the reasons for the change in auditors.
 - (iv) Consider circumstances which would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks.
 - (v) Evaluate the firm's independence and ability to service the prospective client. In evaluating the firm's ability, consider needs for technical skills, knowledge of the industry and personnel.
 - (vi) Determine that acceptance of the client would not violate codes of professional ethics.
- b. Designate an individual or group, at appropriate management levels, to evaluate the information obtained regarding the prospective client and to make the acceptance decision.
- (i) Consider types of engagements that the firm would not accept or which would be accepted only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
- c. Inform appropriate personnel of the firm's policies and procedures for accepting clients.
- d. Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for acceptance of clients.

2. Evaluate clients at the end of specific periods or upon the occurrence of specified events to determine whether the relationships should be continued.
 - a. Conditions could include:
 - (i) The expiration of a time period.
 - (ii) A major change in one or more of the following--
 - (a) Management
 - (b) Directors
 - (c) Ownership
 - (d) Legal advisors
 - (e) Financial condition
 - (f) Litigation status
 - (g) Nature of the client's business
 - (h) Scope of the engagement.
 - (iii) The existence of conditions which would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.
 - b. Designate an individual or group, at appropriate management levels, to evaluate the information obtained and to make continuance decisions.
 - (i) Consider types of engagements that the firm would not continue or which would be continued only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
 - c. Inform appropriate personnel of the firm's policies and procedures for continuing clients.
 - d. Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for continuance of clients.

Policy--Inspection

- F. The firm should monitor the effectiveness of its quality control policies and procedures.

Procedures

1. Define the scope and content of the firm's inspection program.
 - a. Determine the inspection procedures necessary to provide reasonable assurance that the firm's other quality control policies and procedures are operating effectively.
 - (i) Determine objectives and prepare instructions and review programs for use in conducting inspection activities.
 - (ii) Provide guidelines for the extent of work and criteria for selection of engagements for review.
 - (iii) Establish the frequency and timing of inspection activities.
 - (iv) Establish procedures to resolve disagreements which may arise between reviewers and engagement or management personnel.
 - b. Establish levels of competence, etc., for personnel to participate in inspection activities and the method of their selection.
 - (i) Determine criteria for selecting reviewers, including levels of responsibility in the firm and requirements for specialized knowledge.
 - (ii) Assign responsibility for selecting inspection personnel.
 - c. Conduct inspection.
 - (i) Review and test compliance with applicable quality control policies and procedures.
 - (ii) Review selected engagements for compliance with professional standards and with the firm's quality control policies and procedures.

2. Provide for reporting inspection findings to the appropriate management levels, for monitoring actions taken or planned, and for overall review of the firm's quality control system.
 - a. Discuss inspection review findings on engagements reviewed with engagement management personnel.
 - b. Discuss inspection findings with appropriate management personnel.
 - c. Report inspection findings and recommendations to firm management together with corrective actions taken or planned.
 - d. Determine that planned corrective actions were taken.
 - e. Determine need for modification of quality control policies and procedures in view of results of inspection and other relevant matters.

APPENDIX C

QUALITY CONTROL IN AUDITING

Foreward

Subsequent to a request by the NIVRA Council to prepare recommendations "concerning the measures to be taken in the context of the co-responsibility for the work of other registeraccountants with whom one works and concomitant guidelines regarding measures which can or should be taken to guarantee quality of professional performance," a working group issued, on November 3, 1976, a draft opinion on quality control in auditing. The draft was discussed during the general meeting of members of the Institute in December 1976. Written comments were also received, and, after their careful study, the draft was amended on several points. The basic structure and substance, however, required no major revisions. The Opinion addresses itself primarily to problems of quality control relative to the attest function of the public accountant; insofar as it concerns cooperation between registeraccountants, the Opinion focusses on situations in which registeraccountants operate under a joint name.

Although there exists a close relationship between quality control and joint responsibility, no distinction is made in the recommendations between measures aimed at quality control in general and those required by situations in which more than one registeraccountant operates under one name.

Only a few recommendations are limited in their application to organizations employing a large number of registeraccountants. Apart from these few exceptions, the recommendations cover quality control problems encountered by all accounting firms as well as sole practitioners.

The Council of NIVRA is of the opinion that the detailed recommendations which follow cannot be disregarded for long without diminishing the quality control.

QUALITY CONTROL IN AUDITING

In terms of the qualitative requirements of his work, the registeraccountant must look not only to his obligations to his client but, in particular, to the Rules of Conduct and Professional Practice of NIVRA (see PILOT 1). The Rules incorporate a number of articles which are aimed, directly or indirectly, at maintaining a quality in professional performance.

The majority of these articles has been formulated sufficiently concretely as to leave room for little or no difference of opinion on them. This is especially true of the articles concerning auditors' statements and reports, conditions for practicing under a joint name and the basic postulates of the profession such as impartiality, confidentiality and independence. Thus, in regard to these articles, recommendations for organizational measures to facilitate proper control of them should suffice.

Some other articles in the Rules of Conduct and Professional Practice, however, leave more room for interpretation. This applies particularly to the Rule for registeraccountants acting as auditors contained in Article 11:

"A registeraccountant shall make no statement on the outcome of his activities unless his expert knowledge and the work done by him provide a sound basis for his statement. He shall take care that such statement reflects clearly the outcome of his activities."

There are two basic elements in the "sound basis" as formulated in Article 11:

- (1) the work done
- (2) the expert knowledge.

re(1): the work done

The work carried out may be subdivided into: its professional-technical aspect (the actual substance of the task in each concrete situation, the determination of procedures and techniques) and its organizational aspect (the establishment of the *modus operandi*, the planning and use of manpower and other means).

Professional techniques in a narrow sense as referred to above are not, for the Netherlands, as yet codified as they are for the American profession. It is the intention, however, to make a start with codification subsequent to international guidelines and statements on auditing, a

process in which NIVRA participates. Such crystallization of standards will also offer certain advantages in the context of quality-control procedures. In this particular Opinion, the emphasis of the formulated recommendations is on the organizational aspects of the work to be carried out.

re(2): expert knowledge

The second element of the "sound basis" concept relates to professional competence, a requirement which applies equally to both the auditor and his assistants. It is the system of professional education in particular which serves the registeraccountant in acquiring the knowledge necessary for the performance of his certifying function.

Professional competence can only be acquired if education is complemented with the necessary practical experience. Moreover, professional competence has to be maintained through permanent education. The case will nevertheless arise in practice that the nature or scope of the audit assignment is such that specialized expertise is required; one could think in this connection of the use of advanced computer systems for accounting purposes, public finance, banks and insurance companies, internationals, and so on.

RECOMMENDATIONS

The recommendations either relate to special aspects of quality control or are geared to critical phases in the auditing process. It is possible that not all thirty recommendations carry, for all circumstances and for each engagement, the same weight. On the other hand, the various recommendations are interdependent. It is the responsibility of each group of cooperating accountants, as well as of the sole practitioner, to select such sets of measures of quality control as meet the purpose of the recommendations in a given instance. It should be left to the judgment of the practicing auditor to determine the emphasis to be given to one or another method in each concrete situation. In cases where accountants operate jointly, it will not be possible to dismiss any of the recommendations for long without adversely affecting the quality control.

A. Recommendations regarding the execution of audit assignments in general

1. To formulate general principles underlying the carrying out of professional work and, where

possible, to develop standards for setting up audit programs.

2. To draft instructions and manuals, including a questionnaire to assure the adequate completion of all work (the so-called "audit-completion checklist").
3. To use a standardized contents section and determine the minimum information required in the audit files so as to facilitate accessibility to the files for auditors not directly involved in the execution of the assignment.
4. To use time budgets and planning schemes for the execution of the different assignments and to make periodic comparisons between the schedules and the actual situation so as to avoid lapses in execution resulting from time pressures.
5. To supervise periodically and critically the number of staff members engaged simultaneously in an assignment under the supervision and responsibility of an executive so as to assure that professionally justified limits for the span of control are not exceeded.
6. To introduce a proper system of staff planning geared to the partner and staff needs of the firm (or department) at all levels.
7. To organize an adequate and efficient, up-to-date documentation system covering national and international professional literature and related topics.
8. To assure the availability (either from within or from outside the firm or department) of the required specialized expertise relating to specific aspects of the audit practice (EDP audit, specialized industries, international practice and so on) and to make consultation of experts compulsory where the situation demands.
9. To establish a professional-technical committee to advise on special problems, internal differences of opinion, the preparation of position papers for the firm, etc.
10. To establish a professional-technical committee to supervise, on a test basis, adherence to the auditing and reporting standards set and to discuss

its findings with the individuals concerned and/or report these to the proper bodies within the organization.

B. Recommendations regarding the execution of individual assignments

1. To accept only assignments for which one is adequately equipped in terms of manpower and expertise so as to warrant a professional-technical execution on a responsible basis.
2. To ensure that the client is sufficiently aware of the significance of the audit assignment and the concomitant responsibilities and tasks of the registeraccountant, preferably through the use of a specified, written assignment agreement.
3. To examine and record the basic principles and relevant details of the organization of the client, in particular the accounting system and controls, as well as to evaluate and periodically update the changes occurring therein.
4. To draft and periodically review detailed audit programs as well as to control work in progress with the help of a detailed job-planning scheme.
5. To allocate the execution of the assignment as a whole or in part to those individuals having adequate experience and expertise for the particular job or who can obtain such knowledge on a timely basis.
6. To assure proper supervision of the execution of the assignment on all levels, a.o., by reviews of audit notes and papers, etc.
7. To record all considered decisions with regard to difficulties and problems encountered in carrying out the assignment as well as to take such steps as are necessary to guarantee that all relevant opinions within the audit team are adequately reflected in the end results of the work carried out.
8. To have the reports and opinions--if possible prior to issue--reviewed by a second registeraccountant with adequate experience. In special instances the reviewing registeraccountants should preferably not have been involved in the execution of the assignment.

9. Where necessary, to ask expert opinion on matters like taxes, pensions, etc.
 10. To keep alive a critical attitude in the execution of the different assignments by integral or partial changes in the composition of the audit team.
- C. Recommendations concerning the professional development and prerequisites of partners and staff involved in audit assignments
1. To set minimum standards for personnel regarding education, attitude and motivation.
 2. To acquaint new staff members with the concepts, rules and standards set by the firm (or department), a.o., by way of introductory courses, written instructions, etc.
 3. To organize on-the-job training for assistants in view of, inter alia, its educational value.
 4. To periodically evaluate staff performance on all relevant aspects and to discuss the results with the staff members concerned.
 5. To make sure on a timely basis that staff members are adequately trained, especially in the field of accounting systems and auditing, and to encourage them to follow professional courses.
 6. To set standards of education and experience for persons serving managerial functions and qualified to sign for the firm (or department).
 7. To stimulate broad practical experience at all levels, taking into account individual potential as a crucial part of career planning.
 8. To periodically distribute information with regard to new professional developments and changes in legislation relevant to the profession.
 9. To continuously encourage the required mental attitude in professional affairs, in particular relating to the maintenance of a critical frame of mind, independence and confidentiality.
 10. To maintain professional competence, e.g., through the organization of internal seminars, encouraging staff to attend courses in the context of permanent education and others.

APPENDIX D

CHECKLIST FOR EVALUATING AUDIT TRAINING

- I. Evaluation of training philosophy, goals, and objectives
 - ___ A. Gain an understanding of the mission, organizations, policies and responsibilities of the individuals charged with the audit training responsibility.
 - ___ B. Study the overall operation of the training program.
 - ___ C. Compare the training philosophy, goals, and objectives with:
 - ___ (1) the profession's standards (e.g., GASD, SAS No. 4, Voluntary Quality Control Review Programs for CPA firms).
 - ___ (2) the firm's audit training philosophy and objectives.
 - ___ D. Determine if audit training philosophy, goals and objectives are being implemented.
 - ___ E. Determine if firm monitors whether goals and objectives are being met.
- II. Review training curriculum for:
 - ___ A. Completeness and relevancy
 - ___ B. Currency
 - ___ C. Location of courses
 - ___ D. Internal monitoring system
- III. Review selected courses for:
 - ___ A. Content
 - ___ B. Delivery system

- IV. Review quality of instruction in firm programs with respect to:
 - ___ A. Instructor selection
 - ___ B. Instructor training
 - ___ C. Instructor preparation
 - ___ D. Instructor evaluation
 - ___ E. Instructor recognition
- V. Evaluate the training information system with respect to:
 - ___ A. Record keeping for firm purposes
 - ___ B. Record keeping for benefit of regulatory groups or associations
- VI. Evaluate the training facilities
 - ___ A. Physical facilities
 - ___ B. Training equipment
 - ___ C. Library resources
- VII. Evaluate the administration of training, including:
 - ___ A. The training organization
 - ___ B. Policies as to training
 - ___ C. Partner participation and supervision
- VIII. Evaluate participants
 - ___ A. Matching participants with the appropriate course
 - ___ B. Ascertaining if participant's performance is reviews
- IX. Review on-the-job training
 - ___ A. Review policies and procedures relating to on-the-job training

- ___ B. Determine firm's commitment to on-the-job training (e.g., is it emphasized in staff evaluations)
- ___ C. Determine if staff is formally trained on how to conduct on-the-job training
- ___ D. Determine if firm's executives monitor the effectiveness of the on-the-job training.

Source: [Ref. 31:p. 12]

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